Why you should accumulate Dr. Reddy’s Lab shares

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6-7 minutes

Post the turnaround in FY20, Dr. Reddy’s (DRL) has a broader revenue base in India and a US portfolio aligned to generate value and volume. While the stock trading at 21 times FY23 EPS has factored in the positives, execution in biosimilars, vaccines and core business can add further value. Long term investors with a healthy risk appetite can accumulate the stock on dips.

DRL stock price corrected by 13 per cent following Q1 FY22 results in July-2021 as investors expectations were not met on margins, US portfolio growth and API realisations. Expectations of DRL making a mark in the initial Covid vaccination drive were also tempered as management reported supply issues in Sputnik V. Shares have made only a marginal recovery since then. While pricing complexity is structural in US, DRL can deliver strong launches improving revenues and margins, providing cushion to the lumpy nature of API sales.

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US portfolio

North America accounts for 37 per cent of revenues while, India, EM and API business account for 17-18 per cent each in FY21. DRL has had a good launch rate in US in the last two years of around 27-28 products in FY20 and FY21. More importantly the portfolio consistently included limited competition products with good margin potential at regular intervals. These included vigabatrin (antiepileptic), naloxone hydrochloride-opioid OD (under exclusive conditions for a limited period), generic Ciprodex (anti-infectives), Vimovo (pain) and Suboxone (addiction). DRL expects to continue with the same launch rate and limited competition mix. Recent set of limited-competition products were launched only towards the end of Q1 FY22 including generic Vascepa (cholestrol), Ertapenem injections (antibiotics) and generic Kuvan (PAH). These combined with 25-30 launches per annum are critical to sustaining US$ 250 million quarterly run rate in the mid-term. The slight delay in launch of new products actually laid bare the price erosion in base portfolio in the first quarter. DRL also joins the limited players - Sun, Cipla, Cadila and Natco Pharma in partial access to 7 billion dollar Revlimid (Multiple myeloma) market, starting from FY23 and complete access from FY26. Even as terms of agreement (most likely single digit market share initially) and the final tally of players with similar access is still unknown the potential revenues can move the needle for DRL.

Inorganic expansion by acquiring products/portfolios has not fared well for DRL (high impairment and milestone payments), but two recent sales from the acquired portfolios have given a silver lining to the strategy at its end. E7777 (acquired from Eisai in 2016) which was under development in Phase 3 clinical trials for CTCL (cutaneous T-cell lymphoma) was sold to Citius Pharmaceuticals. DRL can realise US$ 40 million upfront and other milestones based on progress. Similarly, Oral celecoxib which was developed till commercialisation stage by DRL, was sold to another firm for $ 6 million upfront and other milestones.

Biosimilars and vaccines

DRL has a strong background in biosimilars (Filgrastim, Peg-GCSF, Rituximab, Bevacuzumab, and Trastuzumab - biologics for cancer treatment) for EMs which is now being expanded across lucrative developed markets. Rituximab in Phase 3 clinical program and Pegfilgrastim partnered with Europe based Fresenius Kabi, are in advanced stages. While the two will be fourth or fifth entrants in their respective markets, DRL aims for early presence in 3 other biosimilars being developed. DRL possess a large portfolio of 11 biosimilars under development implying a long run way of development. DRL relies on its extensive hospital network in EM countries but may look for partners in marketing in developed markets, hedging its exposure, at least in the initial stages.

Sputnik V was launched in Sep-2021 in India as early supplies from RDIF (Russian Direct Investment Fund) were delayed, which led to DRL missing the initial volumes in the vaccine drive. With six local manufacturers for the vaccine, 250 million doses agreement including exports, Sputnik V light (single dose variant) in development and pricing which is marginally above the market, DRL can still find demand. DRL has access to the backend of initial inoculation drive (82 crore doses administered by mid-September), export markets, follow on booster shots or mix of these three in leveraging its agreement with RDIF.

Within domestic markets, DRL strengthened its domestic portfolio with the addition of Wockhardt's brands in Q4 FY20 for a sum of ₹1,850 crore. On a wider basket, DRL is now investing in digital capabilities in branded markets (Russia, CIS and India) and also adding OTC and nutraceuticals to its portfolio base. The sustained investment in efficiencies and expansion will impact margins in the short run but can leverage DRL's presence in domestic markets, which is suboptimal compared to its peers.

Valuation

DRL scripted a sharp turnaround from FY19 as it recovered from flat revenue growth in FY16-19, and delivered 11 per cent CAGR growth in FY19-21. DRL recovered from its plant issues, focused on Indian markets and rationalised its US generics portfolio. The strong margin trajectory was interrupted by price erosion and lack of meaningful launches in Q1 FY22. DRL's management is confident of reaching industry leading margins of 25 per cent shortly even as high R&D and efficiency related investments continue. Contribution from recent high value launches and better product mix can drive its margins.

On valuation front, DRL is valued at 21.3 times FY23 earnings (Adj. earnings CAGR of 25 per cent over FY21-23) which is marginally below its peers (Bloomberg consensus). Corrections can provide better entry points for investors, with some margin of safety.