



Dr. Reddy's Laboratories

STOCK INFO.	BLOOMBERG
BSE SENSEX: 15,062	DRRD IN
	REUTERS CODE
S&P CNX: 4,469	REDY.BO

21 July 2009

Buy

Rs790

Previous Recommendation: Buy

Equity Shares (m)	168.4
52-Week Range (Rs)	829/357
1,6,12 Rel. Perf. (%)	4/6/8
M.Cap. (Rs b)	133.0
M.Cap. (US\$ b)	2.7

YEAR	NET SALES	PAT	EPS	EPS	P/E	P/BV	ROE	ROCE	EV/	EV/
END	(RS M)	(RS M)	(RS)	GROWTH (%)	(X)	(X)	(%)	(%)	SALES	EBITDA
03/09A*	69,441	-5,169	-30.7	-210.6	-25.7	3.2	-12.3	-3.3	2.1	11.5
03/10E*	70,832	8,020	47.6							
03/10E	68,734	7,286	43.3		18.2	2.8	16.8	14.2	2.0	12.0
03/11E	76,031	8,557	50.8	17.4	15.5	2.5	15.9	13.8	1.9	11.4
03/11E*	79,481	10,121	60.1	38.9						

* - includes one-off upsides from Imitrex AzG

- Sales up 21%, PAT up 81%:** Dr. Reddy's Labs 1QFY10 results were above expectations. Sales improved 21% to Rs18.18b while PAT grew by 81% to Rs2.44b. Adjusted for one-time contribution from Imitrex AzG (Rs2.1b of revenues and Rs734m to PAT), core revenues have grown by 7% to Rs16.1b while core PAT has recorded 23% growth to Rs1.65b v/s our estimate of Rs1.53b.
- Core EBITDA Margins better than estimates:** While reported EBITDA Margins at 20.7% were partly boosted due to contribution from Imitrex AzG, we estimate that core EBITDA Margins (excl one-off upsides and one-time write-offs) were 16.6% for the quarter, a growth of 450bp YoY. Operational performance was better than estimates due to better product-mix and lower than expected other expenses and R&D costs.
- Reiterates FY10E Guidance:** DRL has maintained its FY10E guidance for a top-line growth of 10% (in INR terms) including contribution from Imitrex AzG and Omeprazole OTC in the US.
- Upgrading estimates by 6-7%:** We have upgraded our core EPS estimates for FY10E and FY11E by 6-7% each. However, we have revised our core revenue estimates downwards by about 1%, in-line with lower than expected 1QFY10 revenues. Our upgrade reflects DRL's focus on a moderate but more profitable growth and excludes upsides from Imitrex AzG & Omeprazole OTC.
- Target price of Rs864; maintain Buy:** Traction in the branded formulations and US businesses, and focus on improving profitability will be the key growth drivers for DRL over next two years. Based on our revised estimates, we expect EPS of Rs43.3 for FY10 (vs net loss for FY09) and Rs50.8 for FY11 (up 17.5%), leading to 22% EPS CAGR for FY08-11. Our estimates exclude the upsides from patent challenges / low-competition opportunities in the US. DRL is currently valued at 18.2x FY10E and 15.5x FY11 earnings. Maintain **Buy** with a target price of Rs864.

QUARTERLY PERFORMANCE-US GAAP										(Rs Million)
Y/E MARCH	FY09				FY10				FY09	FY10E
	1Q	2Q	3Q	4Q	1Q	2QE	3QE	4QE		
Gross Sales	15,038	16,152	18,401	19,850	18,189	16,440	17,940	18,263	69,441	70,832
YoY Change (%)	25.1	27.5	49.3	52.7	21.0	1.8	-2.5	-8.0	38.9	2.0
EBITDA	1,815	2,326	4,202	4,614	3,767	2,466	2,781	3,061	12,946	12,075
Margins (%)	12.1	14.4	22.8	23.2	20.7	15.0	15.5	16.8	18.6	17.0
Depreciation & Amortization	391	472	339	14,339	507	500	500	521	15,526	2,028
Other Income	166	-338	-1,540	158	-89	-75	-75	-145	-1,416	-384
Profit before Tax	1,590	1,516	2,323	-9,567	3,171	1,891	2,206	2,395	-3,996	9,662
Tax	242	303	399	240	726	321	375	220	1,173	1,643
Rate (%)	15.2	20.0	17.2	-2.5	22.9	17.0	17.0	9.2	-29.4	17.0
Reported PAT	1,348	1,213	1,924	-9,807	2,445	1,570	1,831	2,175	-5,169	8,019
Minority Interest	0	0	0	0	0	0	0	0	0	0
Net Profit	1,348	1,213	1,924	-9,807	2,445	1,570	1,831	2,175	-5,169	8,019
One Time & EO (Exp)/Inc	0	0	1,027	1,243	734	0	0	0	2,270	734
Adjusted PAT	1,348	1,213	897	-11,049	1,711	1,570	1,831	2,175	-7,438	7,285
YoY Change (%)	-26.3	0.3	-	-1,170.3	26.9	29.4	104.1	-119.7	-259.0	-197.9
Margins (%)	9.0	7.5	4.9	-55.7	9.4	9.5	10.2	11.9	-10.7	10.3

Note-DRL commenced IFRS reporting wef 2QFY09. Past financials are as per US GAAP. Estimates do not include one-off upsides.

Traction in US coupled with currency depreciation leads topline growth

DRL's 1QFY10 sales improved 21% to Rs18.18b (Rs16.1b excluding one-time generic Imitrex vs estimate of Rs16.7b) while PAT grew by 81% to Rs2.44b. Adjusted for one-time contribution from Imitrex AzG (Rs2.1b of revenues and Rs734m to PAT), core revenues have grown by 7% to Rs16.1b while core PAT has recorded 23% growth to Rs1.65b v/s our estimate of Rs1.53b. DRRD has provided Rs515m for damages related to loss of Olanzapine patent litigation in Germany and approx Rs500m as charges for reduction in sales force in Germany from 110 to 50 MRs. While we view these as one-time charges, we classify them as operational expense.

Revenue growth was mainly led by higher growth in USA, up 112% to Rs6b. Like-to-like growth in US was 38% partly boosted by YoY currency depreciation of 16%.

Revenues in Germany declined by 36% to Rs1.6b, due to de-stocking by trade channels and lower volumes for non-AOK products. DRL's contracts with AOK do not include its top-10 products and hence lower volumes of these products have a significant adverse impact on the top-line. Management has indicated that, post the AOK tender, a few other insurance players are expected to announce their tenders thus implying a complete shift to a pure generic market from a branded generic market.

Revenues in Russia & CIS declined by 3% to Rs 1.87b due to flat sales in Russia (at Rs1.5b), which were impacted because of slow-down in demand, de-stocking by trade channels and unfavourable currency movement. Domestic formulations sales recorded 9% growth and are gradually improving as the impact of new launches is felt. We expect 2HFY10 to be better for this business as compared to 1HFY10.

REVENUE MIX (RS M)

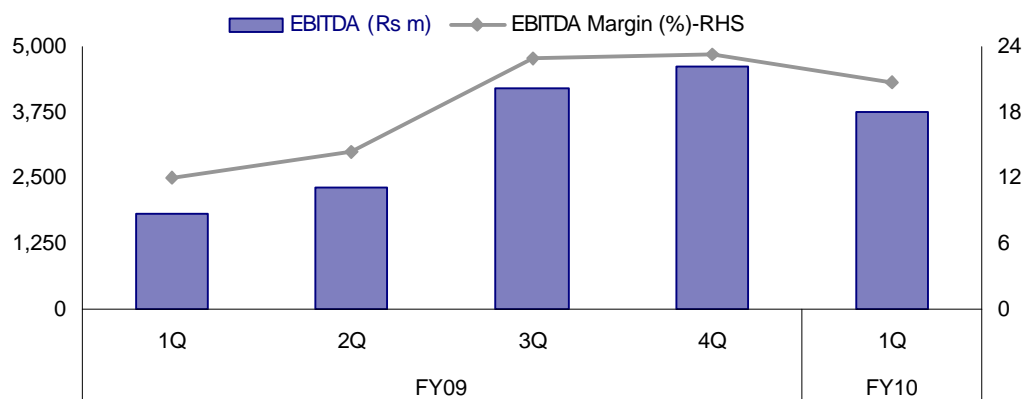
BUSINESS/REGION	1QFY10	1QFY09	CHG. (%)	4QFY09	CHG. (%)
PSAI	4,870	4,613	5.6	4,859	0.2
India	629	722	-12.9	572	10.0
International	4,241	3,891	9.0	4,287	-1.1
Branded Formulations	4,885	4,617	5.8	4,368	11.8
India	2,393	2,202	8.7	2,072	15.5
International	2,492	2,415	3.2	2,296	8.5
Generics	8,135	5,708	42.5	10,301	-21.0
North America	6,026	2,846	111.7	7,205	-16.4
Europe	2,109	2,862	-26.3	3,096	-31.9
Others	300	99	203.0	322	-6.8
Total Revenues	18,190	15,037	21.0	19,850	-8.4

Source: Company/MOSL

Core EBITDA margins better than estimates

While reported EBITDA margins at 20.7% were partly boosted due to contribution from Imitrex AzG, we estimate that core EBITDA Margins (excl one-off upsides and one-time write-offs) were 16.6% for the quarter, a growth of 450bp YoY. Operational performance was better than estimates due to better product-mix and lower than expected other expenses and R&D costs.

EBITDA MARGIN TREND



Source: Company/MOSL

Focus on profitability improvement

DRL management has identified the following initiatives targeted to improve the overall profitability of the company:

- 1. Strategic prioritization in generic markets:** DRL has recently initiated the process of realigning its presence internationally to focus on certain key geographies and has decided to gradually exit from some of the small/marginal markets (contributing < 1% of revenues). Focus markets for future will be US, India, Russia & CIS, Germany and some other key markets. While DRL has not given further details on this initiative, we believe that it is a step towards making the overall business more focused. We view this as a positive development from a long-term perspective.
- 2. Contribution from low-competition opportunities in the US:** The management has guided for one such opportunity every year for the next 5 years. Visible opportunities include potential launch of generic Arixtra and Prilosec OTC (scheduled launch in 2QFY10) with combined annual PAT potential of US\$35-40m. These opportunities span across FY10/11. It is currently enjoying limited competition for Imitrex.
- 3. Ramp-up in the biologics business:** Plans to ramp up its biologics business in emerging markets in the short-to-medium term, and in regulated markets in the long-term (possibly through partnerships). It will be setting up a new capacity for manufacturing of biologics at a cost of about Rs1.5-2b.
- 4. Turnaround in US dermatology business:** DRL expects to turn around its US dermatology business through launch of more products (currently 2 products have been commercialized with a pipeline of 7 more under development).
- 5. Maintain the traction in key emerging markets:** The management expects to sustain the growth traction in key emerging markets of Russia and CIS. Growth for its Indian formulation business has suffered in the past few quarters due to fewer new launches, and changes in the distribution system to re-align trade inventories with underlying demand. Management has indicated that growth for the domestic business will revert back to double digits post 1HFY10.

Reiterates FY10E guidance

DRL management has reiterated its FY10E guidance of 10% top-line growth including contribution from generic Imitrex AzG and Prilosec OTC. Our estimates exclude these one-off upsides. The table below gives details on the guidance:

GUIDANCE FOR FY10E

PARAMETER	GUIDANCE	REMARKS
Overall Sales Growth (%)	10	Includes upsides from generic Imitrex & Prilosec OTC in the US. Excl patent challenge upsides, 1QFY10 top-line grew by 7%. We expect 11% YoY growth partly aided by a favorable currency.
Sales Growth - Germany (%)	De-growth (not quantified)	FY09 revenues were Rs9.9b with 17% EBITDA Margin. 1QFY10 sales were down 36%. Management has guided that the remaining 3 quarters will see some ramp-up over 1QFY10. We estimate a 20% decline for FY10E
Sales Growth - Domestic formulation (%)	NA	FY09 growth was 5% - impacted by lack of new launches & changes in distribution system. Growth to revert back to double-digits from 2HFY10E. 1QFY10 growth was 9%. We have assumed 12% growth for FY10E
Sales Growth - Russia & CIS (%)	NA	FY09 growth was 33%. Mgt has guided for a more moderate growth for FY10E. We have assumed 13% growth for FY10E
Capex (US\$ m)	125	Capex for FY09 was US\$87m
RoCE (%)	16-18	FY09 RoCE was about 14% post the Rs14b write-off related to Germany
Forex hedges outstanding (US\$m)	130	Most of the hedges have been taken between Rs47-50/US\$. These hedges cover approx 30% of DRL's net US\$ exposure excluding forex loans leaving the company exposed to any potential appreciation of the INR v/s the US\$
INR/US\$ assumption for guidance	Rs48-49	Our forecast is currently based on INR/US\$ of Rs47.6
EPS (Rs)	NA	We expect FY10E core EPS at Rs43.3

Source: Company/MOSL

Upgrading estimates

After the better than expected 1QFY10 performance, we have upgraded our core EPS estimates for FY10 and FY11 by 6-7% each. However, we have revised our core revenue estimates downwards by about 1%, in-line with lower than expected 1QFY10 revenues. Our upgrade reflects DRL's focus on a moderate but more profitable growth and excludes upsides from Imitrex AzG.

Valuation and outlook

Traction in the branded formulations and US businesses, and focus on improving profitability will be the key growth drivers for DRL over next two years. Based on our revised estimates, we expect EPS of Rs43.3 for FY10 (v/s net loss for FY09) and Rs50.8 for FY11 (up 17.5%), leading to 22% EPS CAGR for FY08-11. Our estimates exclude the upsides from patent challenges / low-competition opportunities in the US. DRL is currently valued at 18.2x FY10E and 15.5x FY11 earnings. Maintain **Buy** with a target price of Rs864.

Dr. Reddy's Laboratories: an investment profile

Company description

Dr. Reddy's is a vertically integrated company with presence across the pharmaceutical value chain through its core businesses of Global Generics, Pharmaceutical Services & Active Ingredients (PSAI), and Proprietary Products. The company is currently developing bio-generics and NCEs. Key focus markets include India, US, Europe and Russia.

Key investment arguments

- ✎ Company targeting to improve profitability over the next two years led by strategic prioritization in generic markets, contribution from low-competition opportunities in the US, restructuring of German operations, ramp-up in the biologics business and double-digit growth in emerging markets.
- ✎ Core top-line growth to be led by double-digit growth for API exports & the branded formulations business. Company is targeting launch of at least one low-competition/Para-IV product in the US every year till FY13. Visible opportunities include generic Arixtra (FY11 launch) & Prilosec OTC (2QFY10 launch).
- ✎ Long-term revenue target of US\$3b by FY13 (implied CAGR of 21% for FY09-FY13) and RoCE of 25%.
- ✎ Revenue and earnings CAGR of 15% and 22% during FY08-FY11 respectively. FY09 EPS impacted due to Germany write-offs.

Key investment risks

- ✎ The US FDA has, of late, become very stringent in evaluating cGMP compliance and has issued warning letters to many leading Indian players. Any slippages could impact Dr. Reddy's US supplies.
- ✎ Higher than expected currency appreciation could adversely impact future earnings.

Recent developments

- ✎ Received US FDA approval for generic Prilosec OTC - a low-competition opportunity - for the US market.

Valuation and view

- ✎ Expect 22% EPS CAGR for FY08-FY11E; valuations at 18.2x FY10E EPS of Rs43.3 (excl one-offs).
- ✎ We maintain **Buy** with a target price of Rs864 (17x FY11E earnings).

Sector view

- ✎ Emerging markets coupled with Para-IV upsides would remain the key sales and profit drivers in the medium term.
- ✎ We are Overweight on companies that have a differentiated business model for the US market.

COMPARATIVE VALUATIONS

		DRL	CIPLA	RANBAXY
P/E (x)	FY10E	18.2	17.6	-56.4
	FY11E	15.5	16.1	725.4
P/BV (x)	FY10E	2.8	4.0	2.6
	FY11E	2.5	3.4	2.5
EV/Sales (x)	FY10E	2.0	3.5	1.9
	FY11E	1.9	3.0	1.6
EV/EBITDA (x)	FY10E	12.0	14.3	2,113.7
	FY11E	11.4	12.4	33.9

SHAREHOLDING PATTERN (%)

	JUN-09	MAR-09	JUN-08
Promoter	25.8	26.4	25.1
Domestic Inst	19.8	20.2	20.9
Foreign	41.4	39.8	41.9
Others	13.0	13.7	12.1

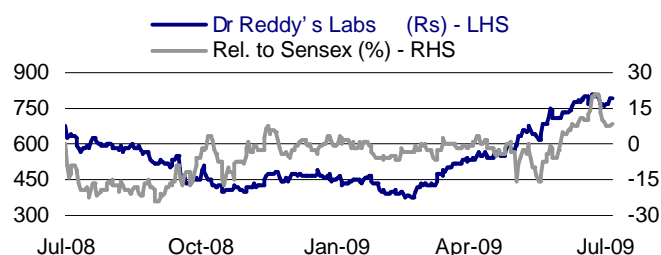
EPS: MOST FORECAST V/S CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY10	47.6	45.0	5.8
FY11	50.8	53.2	-4.5

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
790	864	9.4	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2007	2008	2009	2010E	2011E
Net Sales	65,095	50,007	69,441	70,832	76,031
Change (%)	168.2	-23.2	38.9	2.0	7.3
Other Income	331	409	160	-300	-350
EBITDA	14,429	6,808	12,692	12,075	12,485
Change (%)	801.7	-52.8	86.4	-4.9	3.4
Margin (%)	22.2	13.6	18.3	17.0	16.4
Amortization	3,341	4,194	15,526	2,028	1,825
EBIT	11,088	2,614	-2,834	10,047	10,660
Net Interest Exp	1,055	328	688	0	0
Forex (Gains)/Losses	-137	-745	634	84	0
PBT & EO Expense	10,500	3,439	-3,996	9,663	10,310
Change (%)	600.4	-67.2	-216.2	-341.8	6.7
Extra Ordinary Expense	0	0	0	0	0
PBT after EO Expense	10,500	3,439	-3,996	9,663	10,310
Tax	1,177	-1,229	1,173	1,643	1,753
Tax Rate (%)	11.2	-35.7	-29.4	17.0	17.0
Minority Interest	-3	-10	0	0	0
Reported PAT	9,327	4,679	-5,169	8,020	8,557
PAT adj for EO Items	9,323	4,669	-5,169	8,020	8,557
Add: BetaPharm's profit	0	0	0	0	0
Adjusted Net Profit	9,323	4,669	-5,169	8,020	8,557
Change (%)	579.9	-49.9	-210.7	-255.2	6.7
Margin (%)	14.3	9.3	-7.4	11.3	11.3

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2007	2008	2009	2010E	2011E
Equity Share Capital *	840	841	842	842	842
Reserves	40,739	46,226	41,203	46,965	53,028
Net Worth	41,578	47,067	42,045	47,807	53,870
Loans	24,764	19,542	19,701	19,701	19,701
Deferred Liabilities/Tax	7,085	5,055	3,411	3,411	3,411
Capital Employed	73,427	71,663	65,157	70,919	76,982
Net Fixed Assets	12,703	16,979	21,144	24,344	27,544
Investments	1,331	4,993	730	730	730
Goodwill/Intangible Assets	34,429	33,602	22,179	22,179	22,179
Curr. Assets	36,898	29,284	38,480	42,083	46,297
Inventory	7,546	11,133	13,226	16,291	17,487
Account Receivables	7,669	6,901	14,592	13,458	14,446
Cash and Bank Balance	17,981	7,398	5,596	7,375	9,042
Others	3,702	3,852	5,066	4,958	5,322
Curr. Liability & Prov.	11,934	13,194	17,376	18,416	19,768
Account Payables	4,756	5,427	5,987	7,792	8,363
Other Current Liabilities	7,178	7,768	11,389	10,625	11,405
Net Current Assets	24,964	16,089	21,104	23,666	26,529
Appl. of Funds	73,427	71,663	65,157	70,919	76,982

* IFRS reporting from FY09 onwards. Financials prior to FY09 are as per US GAAP
'E: MOSL Estimates;

RATIOS					
Y/E MARCH	2007	2008	2009	2010E	2011E
Basic (Rs)					
EPS	55.5	27.8	-30.7	47.6	50.8
Cash EPS	75.4	52.7	61.5	59.7	61.7
BV/Share	247.6	279.9	249.7	283.9	319.9
DPS	7.2	3.4	3.1	5.7	6.3
Payout (%)	29.7	28.2	0.0	28.2	29.2
Valuation (x)					
P/E	14.2	28.4	-25.7	16.6	15.5
Cash P/E	10.5	15.0	12.8	13.2	12.8
P/BV	3.2	2.8	3.2	2.8	2.5
EV/Sales	2.1	2.8	2.1	2.0	1.9
EV/EBITDA	9.6	20.6	11.5	12.0	11.4
Dividend Yield (%)	0.9	0.4	0.4	0.7	0.8
Return Ratios (%)					
RoE	22.4	9.9	-12.3	16.8	15.9
RoCE	16.5	4.1	-3.3	14.2	13.8
Working Capital Ratios					
Fixed Asset Turnover (x)	5.9	3.4	3.6	3.1	2.9
Debtor (Days)	43	50	77	69	69
Inventory (Days)	42	81	70	84	84
Working Capital (Days)	39	63	82	84	84
Leverage Ratio					
Current Ratio (x)	3.1	2.2	2.2	2.3	2.3
Debt/Equity (x)	0.6	0.4	0.5	0.4	0.4

CASH FLOW STATEMENT					
(Rs Million)					
Y/E MARCH	2007	2008	2009	2010E	2011E
Op. Profit/(Loss) before Tax	14,429	6,808	12,692	12,075	12,485
Interest/Dividends Recd.	-587	825	-1,162	-384	-350
Direct Taxes Paid	-1,177	1,229	-1,173	-1,643	-1,753
(Inc)/Dec in WC	4,583	-1,708	-6,817	-783	-1,196
CF from Operations	17,247	7,155	3,540	9,265	9,186
EO Expense	0	0	0	0	0
CF from Operating incl	17,247	7,155	3,540	9,265	9,186
(inc)/dec in FA	-7,493	-7,643	-8,268	-5,228	-5,025
(Pur)/Sale of Investments	-94	-3,662	4,263	0	0
CF from Investments	-7,587	-11,305	-4,005	-5,228	-5,025
Issue of Shares	10,296	0	0	0	0
(Inc)/Dec in Debt	-6,231	-5,223	159	0	0
Other Items	3,308	104	-265	0	0
Dividend Paid	-2,765	-1,314	-1,232	-2,258	-2,494
CF from Fin. Activity	4,608	-6,433	-1,338	-2,258	-2,494
Inc/Dec of Cash	14,268	-10,583	-1,802	1,779	1,667
Add: Beginning Balance	3,713	17,981	7,398	5,596	7,375
Closing Balance	17,981	7,399	5,596	7,375	9,042

Note: Reported cashflow differs due to acquisitions & change to IFRS reporting from FY09 onwards

N O T E S



For more copies or other information, contact

Institutional: Navin Agarwal. **Retail:** Manish Shah

Phone: (91-22) 39825500 Fax: (91-22) 22885038. E-mail: reports@motilaloswal.com

Motilal Oswal Securities Ltd, 3rd Floor, Hoechst House, Nariman Point, Mumbai 400 021

This report is for the personal information of the authorized recipient and does not construe to be any investment, legal or taxation advice to you. Motilal Oswal Securities Limited (*hereinafter referred as MOST*) is not soliciting any action based upon it. This report is not for public distribution and has been furnished to you solely for your information and should not be reproduced or redistributed to any other person in any form.

The report is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon such. MOST or any of its affiliates or employees shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. MOST or any of its affiliates or employees do not provide, at any time, any express or implied warranty of any kind, regarding any matter pertaining to this report, including without limitation the implied warranties of merchantability, fitness for a particular purpose, and non-infringement. The recipients of this report should rely on their own investigations.

MOST and/or its affiliates and/or employees may have interests/ positions, financial or otherwise in the securities mentioned in this report. To enhance transparency, MOST has incorporated a Disclosure of Interest Statement in this document. This should, however, not be treated as endorsement of the views expressed in the report.

Disclosure of Interest Statement

Dr. Reddy's Laboratories

- | | |
|---|----|
| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | No |
| 3. Broking relationship with company covered | No |
| 4. Investment Banking relationship with company covered | No |

This information is subject to change without any prior notice. MOST reserves the right to make modifications and alternations to this statement as may be required from time to time. Nevertheless, MOST is committed to providing independent and transparent recommendations to its clients, and would be happy to provide information in response to specific client queries.