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PICK OF THE WEEK

Dr. Reddy's Laboratories Ltd. (DRL)

Rs.758 | Buy

Low Risk – High Return

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Nifty: 4015; Sensex: 13972

Key Stock Data

Sector	Pharmaceuticals
Bloomberg/Reuters	DRRD@IN/REDY.BO
Shares o/s (m)	153.5
Market cap (Rs m)	116,299
Market cap (US$ m)	2,605
3-m daily average vol.	152,729

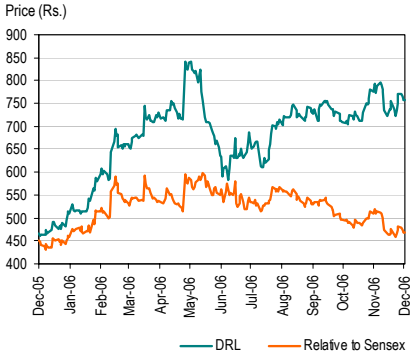
Price Performance

52-week high/low			Rs877/450
	-1m	-3m	-12m
Absolute (%)	(4.4)	4.1	62.8
Rel to Sensex (%)	(10.6)	(13.7)	5.7

Shareholding Pattern (%)

Promoters	27.53
FIIs/NRIs/OCBs/GDR	48.34
MFs/Banks/FIs	11.26
Non Promoter Corporate	1.41
Public & Others	11.47

Stock vs Relative to Sensex



Source: Capitaline

Summary

Dr. Reddy's Laboratories (DRL) is aggressively building its presence in important markets of Europe and US through acquisitions and patent challenges. It's own NCE pipeline (through its associate company Perlecan) has molecules like Balaglitazone (anti-diabetic), which will enter phase III clinical phase in January 2007.

For DRL, in the near term, *Zofran* (Ondansetron) going off-patent in December 2006 is crucial. The current price of DRL discounts our FY07E EPS of Rs.40.1 by 18.9x and FY08E EPS of Rs.41.7 by 18.2x. At the current levels, we believe the downside risk is minimal but good potential upside if things work in its favor. We retain our 'Buy' recommendation on the stock, with a one-year price target of Rs.920 i.e. 22% YoY higher.

Investment highlights

Near term upside likely from Ondansetron

For DRL, Ondansetron generics can notch sales of close to $80 to 100m i.e. around Rs.12 additional EPS (part in Q4FY07 and Q1FY08) in 180 days of exclusive period. As the patent challenge was made before December 2003, we believe DRL's preservation of the exclusivity is strong, but have not factored it in our estimates waiting for further clarity.

Expanding market reach through acquisitions

DRL acquired Germany's fourth largest generics company, Betapharm for 483m euros ($584m) in 2005, giving it 3.5% market share in the German market. This acquisition has been well integrated into DRL, contributing $57m i.e.13% to DRL's Q2FY07 total revenues. Recently $243m was raised by way of ADR, likely to be utilized to reduce debt and for acquisitions as well as expanding the generic portfolio.

Strong H1FY07 numbers driven by authorized generics

Q2FY07 revenues were up 245% YoY at Rs.20bn i.e.$436m, driven by acquisitions of Rs.4bn i.e.$87m and contribution of Rs.8bn i.e.$170m from two new authorized generics in US markets. We estimate H2FY07 revenues from this will drop sharply, compensated by the recent pravastatin launch.

Research pipeline

In the NCE pipeline, Balaglitazone (DRF 2593) is all set to enter Phase III clinical trials in January 2007. DRL also promoted India's first integrated drug development company Perlecan Pharma to which it has assigned 4 of its molecules in NCE pipeline for further research.

Table 1: Financial snapshot (Rs m)

Year-end: March	FY05	FY06	FY07E	FY08E	FY09E
Net sales	19,126	24,077	62,424	59,762	65,738
EBITDA	1,010	2,201	8,401	8,512	10,465
PAT	265	1,397	6,211	6,464	8,022
EPS (Rs.)	2.7	19.4	40.1	41.7	51.9
P/E (x)	280.7	39.1	18.9	18.2	14.6
EV/EBITDA	47.4	36.1	16.3	15.4	12.0

Source: Company reports; IDBI Capital Market Services

Investment positives

Pipeline of Exclusive and Vanilla Generics

DRL has the largest Para IV challenges from India, the only company to have settled 3 Para IV patent litigations in favor of Authorized Generics (AG). The latest being with GSK for blockbuster anti-migraine drug, Imitrex (Sumatriptan Succinate), which allows DRL rights to launch the generic in 4QFY09 ahead of expiry of GSK's patent.

In the H1FY07, we have already seen the big upside from the last of DRL's two AG settlements, Zocor and Proscar. In addition, DRL continues to hold a number of FTF status patent challenges, on which it continues to litigate. We discuss some of the near-term opportunities for DRL.

Zofran (Ondansetron): Big near-term product opportunity for DRL

December 2006 crucial for generic Zofran launch

GSK's last U.S. 'Method of Use Patent' on *Zofran* (Ondansetron) will be expiring on December 24, 2006 (including six months pediatric exclusivity), exposing U.S. *Zofran* market of $900m (sales in 2005) to generic competition. DRL has FTF status being first generic to challenger to GSK's patents on *Zofran* in August 2001. This entitles DRL to 180 days exclusivity marketing rights for its ANDA.

The trial for infringement and validity of the Glaxo's method of use and process patents got completed in June 2004 and closing arguments were heard in May 2005. Till date no decision has been announced.

As the patent challenge was made before December 2003, the preservation of the exclusivity will be based on the interpretation of the date of the 1st 'Court Judgment' on the case. If the Apotex version (November 2006 motion for injunction in D.C.) is to be accepted, then DRL's 180 days exclusivity has already expired on this basis.

We prefer to go with the DRL management view, that its 180 days exclusivity is rights remain preserved there being no court judgment on its 1st ANDA Para 4 challenge. This throws open the possibility of a delay in ANY GENERIC launch till a judgment on DRL's challenge (as we have seen in Ranbaxy's 80mg pravastatin).

We are watching closely, as December 2006 will be crucial. For DRL, Ondansetron generics can notch sales of close to $80m to 100m i.e.around Rs.12 additional EPS (part in Q4FY07 and Q1FY08) in 180 days of exclusive period.

The product opportunity / loss is big for DRL. Considering the big swing, we have not factored this into our earnings. If the exclusivity is not preserved, the market will be open for all generics, more than a dozen generics are waiting in the wings with tentative approvals. In this case DRL sales are likely to be around $20m.

Table 2: Ondansetron details

Brand	API	Strength	Formulation	FTF	US Sales ($ m)	Expiry
Zofran	Ondansetron	Multiple	Tablets Oral	DRL	811 (2005)	24 December 2006

Source: Company reports; IDBI Capital Market Services

Imitrex (Sumatriptan succinate) authorized generic in FY09

Imitrex marketing under AG in FY09

DRL has FTF Para IV filing for *Imitrex*, challenging GSK's patent in December 2003. Last month (October 2006) the case was settled out of court, allowing DRL to launch the generic version ahead of expiry of patent '845 on 6th Feb. 2009.

Imitrex tablets based on 'Sumatriptan Succinate' are indicated for the acute treatment of migraine attacks in adults, with U.S. sales of $640mn in the 12-month period ending June, 2006 according to IMS. If DRL was to launch it just 6-months prior to patent expiry, we estimate it can notch sales of $50 to 60mn, assuming three Sumatriptan Succinate based products in the market.

Table 3: Sumatriptan succinate details

Brand	API	Strength	Formulation	FTF	US Sales ($ m)	Expiry
Imitrex	Sumatriptan	25, 50 and 100mg	Tablets Oral	DRL	640 (2005)	6 February 2009

Source: Company reports; IDBI Capital Market Services

- ***Pravachol* (Pravastatin)**

Generic launch in Q2FY07

Pravachol's patents expired on 20 April 2006, subsequent to which Teva being FTF launched its generic with 180-days exclusivity. DRL along with Apotex, Lek Pharm, Cobalt, Genpharm and Watson have launched their generics on 23 October 2006. While 2005 brand sales were $1.5bn for Bristol Myers, we estimate this product is likely to contribute around $25m to DRL's H2FY07 revenues.

Expanding market reach through acquisitions

- **$243mn ADR proposal to fund further acquisitions**

ADR funds raised for acquisitions

Till now, acquisitions by Indian pharma companies have been mainly in Europe. Such an acquisition will give them a foothold in the US; which is the largest market for generics.

If the price is right, acquisition of pharma companies makes good sense as these provide the front-end for marketing and product registrations in developed markets. This being highly regulated markets, getting fresh approvals takes between 1 to 3 years. Acquisitions gives access to registrations, brands, clients – all of which are critical to gaining market access for pharmaceuticals in developed markets. Margins and profitability can be improved subsequently by shifting production to India.

Betapharm well integrated

Betapharm successfully integrated

DRL acquired Germany's fourth largest generics company, Betapharm for 483m euros ($584m) in 2005, by paying 3 times its sales of around 164m euros. Its acquisition gave DRL a 3.5% market share in the German market, with a portfolio of 145 marketed products and 250 market representatives.

In Q2FY07, Betapharm's revenues at Rs.2.6bn contributed almost 69% to Dr. Reddy's total European business. Post-acquisition, DRL has been able to successfully integrate the operations of Betapharm, improving gross margins of Betapharm to 56% as against 53% in the last quarter. Despite the anticipated price cuts to be enforced by German Government in November, the management expects margins to be maintained.

Table 4: Dr. Reddy's development pipeline in discovery research

Compound	Therapeutic Area	Status	Development Partner	Details
DRF 2593	Metabolic Disorders	Phase II completed	Rheoscience	Entering Phase III in January 2007
DRF 10945	Metabolic Disorders	Phase II in progress	Perlecan	Treatment of dyslipidemia, Phase II studies in Canada
RUS 3108	Cardiovascular	Phase I in progress	Perlecan	Treatment of atherosclerosis
DRL 11605	Metabolic disorders	Phase I initiated	Perlecan	Treatment of obesity, Phase I in Canada
DRL 16536	Metabolic disorders	Pre-clinical	Perlecan	Treatment of diabetes
DRF 1042	Oncology	Phase I	Clintec	Phase I completed
DRL 12424	Cardiovascular	Pre-clinical	Dr. Reddy's	Treatment of Dyslipidemia

Source: Company reports; IDBI Capital Market Services

Perlecan Pharma: Perlecan Pharma Private Ltd was promoted by Dr. Reddy's Laboratories Ltd. along with Citigroup Venture Capital International Growth Partnership Mauritius Ltd and ICICI Venture Funds Management Ltd. Perlecan Pharma is India's first integrated drug development company. Four of the seven NCE candidates of DR. Reddy's research pipeline have been assigned to Perlecan that are DRL 10945, RUS 3108, DRL 11605 and DRL 16536. Citigroup and ICICI Venture have contributed $22.5m in this spin off while Dr. Reddy's pie is of $7.5m in this spin off. Perlecan provides a model for a rapid development in current and future NCE assets of Dr. Reddy's and seeks out-licensing and co-development opportunities enhancing the value of the pipeline.

Rheoscience Agreement: DRL inked a pact with Rheoscience for joint development and commercialization of its most advanced NCE candidate, Balaglitazone (DRF 2593). According to this agreement, Rheoscience will fund all the costs associated with the phase III clinical trials that would be starting in January 2007. DRL will be paying a pre-determined amount to Rheoscience towards its share of development costs while retaining the marketing rights for North America, Japan and RoW except Europe (excluding Russia and CIS) and China.

Financials

The 199% YoY growth in the revenue for H1FY07 was clearly propelled by the growth in generics segment that too mainly because of the authorized generics from Merck (*Zocor* and *Proscar*). This was also aided by a robust growth in API and branded finished dosages especially in emerging markets like CIS, Brazil, and Turkey.

The operating income before forex adjustment also showed a good improvement of 465% YoY. The operating margin almost doubled from 8.86% in H1FY06 to 16.75% in H1FY07 due to better cost-efficiency aided by hefty gross margins of different business segments.

However, we see a slump in the revenues on sequential basis in the next quarter, as the inventory for the authorized generics is available for few weeks. The recent price cuts done in Germany in anticipation of the Government applying price cuts in November and would be realized in the next quarter's results. But still Betapharm business is expected to do well amidst these price fluctuations. The management also quoted regarding the talks they are having with 4-5 generic players to have more authorized generics in pipeline with the expansion of product portfolio.

The debtor's turnover ratio increasing from 69 in FY05 to 77 in FY06 gives clear indication about efficient management of credit that we expect to be maintained in current fiscal.

Financial summary (Consolidated US GAAP)

Profit and loss account

(Rs m)

Year-end: March	FY05	FY06	FY07E	FY08E	FY09E
Net sales	**19,126**	**24,077**	**62,424**	**59,762**	**65,738**
Raw material	6,015	8,310	31,212	29,881	32,869
Employee cost	2,938	3,507	4,018	4,603	5,259
Other manufacturing expenses	342	600	615	630	646
Selling and distribution	6,775	8,029	14,358	13,148	14,462
R&D expenses	2,803	2,153	3,121	2,988	3,287
Operating profit	**162**	**1,478**	**9,101**	**8,512**	**9,215**
Other income	454	534	(700)	0	1,250
Liscencing income	393	190	0	0	0
EBITDA	**1,010**	**2,201**	**8,401**	**8,512**	**10,465**
Depreciation	350	420	425	432	437
PBT	**660**	**1,782**	**7,976**	**8,080**	**10,028**
Tax	(94)	258	1,553	1,616	2,006
Effective tax rate (%)	(14)	15	20	20	20
PAT (before non-recurring items)	**754**	**1,523**	**6,423**	**6,464**	**8,022**
Non-recurring expense	(489)	(126)	(212)	0	0
PAT(after non-recurring items)	**265**	**1,397**	**6,211**	**6,464**	**8,022**
Net income	**207**	**1,485**	**6,151**	**6,404**	**7,962**

Source: Company reports; IDBI Capital Market Services

Balance sheet

(Rs m)

Year-end: March	FY05	FY06	FY07E	FY08E	FY09E
Share capital	383	383	767	767	767
Reserves	20,571	21,888	27,667	31,835	38,314
Net worth	**20,953**	**22,272**	**27,434**	**32,602**	**39,081**
Loans	2,827	30,995	31,000	31,000	31,000
Deffered taxes and others	610	6,403	6,403	6,403	6,403
Capital employed	**24,391**	**59,670**	**64,837**	**70,005**	**76,484**
Current assets					
Inventory	3,500	6,895	17,876	17,113	18,826
Sundry debtors	3,598	5,054	13,104	12,545	13,800
Cash and bank balances	9,346	9,788	11,673	17,683	23,179
Others	1,599	2,814	2,814	2,814	2,814
Less: Current liabilities					
Sundry creditors	1,555	3,791	21,378	20,466	22,513
Other liabilities	968	2,224	2,224	2,224	2,224
Provisions	2,375	3,083	3,083	3,083	3,083
Net current assets	**13,144**	**15,452**	**18,781**	**24,381**	**30,798**
Net fixed assets	**9,759**	**42,980**	**44,555**	**44,123**	**44,186**
Investments	1,487	1,238	1,500	1,500	1,500
Application of funds	**24,391**	**59,670**	**64,837**	**70,004**	**76,484**

Source: Company reports; IDBI Capital Market Services

Ratios

Year-end: March	FY05	FY06	FY07E	FY08E	FY09E
Basic (Rs)					
Consolidated EPS	2.7	19.4	40.1	41.7	51.9
Cash EPS	7.3	24.9	43.0	44.7	54.9
BV per share	273.8	291.1	179.3	213.1	255.4
DPS	4.3	4.3	6.5	8.1	9.7
Payout (Incl. Div. Tax) (%)	43.6	21.6	15.4	19.1	18.5
Valuation					
P/E (x)	269.5	37.7	18.2	17.5	14.1
Cash P/E (x)	100.2	29.3	17.0	16.3	13.3
EV (m)	47,854	79,579	137,014	131,004	125,508
EV/EBITDA (x)	47.4	36.1	16.3	15.4	12.0
EV/Sales (x)	2.8	3.4	2.2	2.2	1.9
Price to book value	2.7	2.5	4.1	3.4	2.9
Dividend yield (%)	1	1	2	2	3
Profitability ratios (%)					
RoE	3.6	6.8	23.4	19.8	20.5
RoCE	5.6	4.4	13.6	12.8	14.3
Turnover ratios					
Debtors (Days)	69	77	77	77	77
Inventory (Days)	67	105	105	105	105
Creditors (Days)	94	167	250	250	250
Asset turnover (x)	1.3	2.5	1.1	1.2	1.2
Leverage ratio					
Debt/Equity (x)	0.1	1.4	1.1	1.0	0.8

Source: Company reports; IDBI Capital Market Services

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