

INDIA

Dr. Reddy's Laboratories

18 September 2009

DRRD IN **Outperform**

Stock price as of 17 Sep 09	Rs	835.15
12-month target	Rs	920.00
Upside/downside	%	+10.2
Valuation - DCF	Rs	900.00

GICS sector pharmaceuticals, biotechnology & life sciences

Market cap	Rs m	140,792
30-day avg turnover	US\$m	1.7
Market cap	US\$m	2,924
Number shares on issue	m	168.6

Investment fundamentals

Year end 31 Mar		2009A	2010E	2011E	2012E
Total revenue	m	62,240	67,336	75,420	84,312
EBIT	m	6,828	8,128	9,878	11,326
EBIT Growth	%	25.3	19.0	21.5	14.7
Recurring profit	m	6,300	7,763	10,023	11,981
Reported profit	m	-5,168	8,824	10,549	11,822
Adjusted profit	m	5,125	6,444	8,319	9,944
EPS rep	Rs	-30.70	52.42	62.66	70.22
EPS rep growth	%	0.0	0.0	19.5	12.1
EPS adj	Rs	30.44	38.27	49.42	59.07
EPS adj growth	%	-20.7	25.7	29.1	19.5
PE rep	x	nmf	15.9	13.3	11.9
PE adj	x	27.4	21.8	16.9	14.1
Total DPS	Rs	4.38	4.82	5.30	5.83
Total div yield	%	0.5	0.6	0.6	0.7
ROA	%	8.2	10.4	12.6	12.7
ROE	%	11.5	14.0	15.2	15.3
EV/EBITDA	x	14.5	11.9	10.2	9.1
Net debt/equity	%	32.3	5.5	-10.9	-23.1
Price/book	x	3.3	2.8	2.4	2.0

DRRD IN rel SENSEX performance, & rec history



Source: FactSet, Macquarie Research, September 2009 (all figures in INR unless noted)

Analyst

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Getting the act right

Event

We met the management of the company recently and came back comfortable with our thesis on the stock. The focus is now on profitable growth which should be reflected in coming quarters. We maintain our Outperform rating and highlight it as one of our top conviction picks in the Indian pharmaceutical space.

Impact

India – getting the act right: With renewed focus on the India business, management is confident of growing faster than the market. For first four months (Apr-Jul 09), IMS secondary sales growth for DRRD was ~15% well ahead of market growth of ~13%. The increased momentum should be reflected in primary sales in coming quarters and does pose upside risk to our 11% growth forecast for FY10. Two biosimilars are slated to be launched in 2H FY10.

Russia – concerns abating: Inventory correction by trade, coupled with liquidity issues, impacted the Russian business in 1Q FY10. Collections have been strong in recent months providing leeway to free-up credit limit to distributors. The secondary sales trend has been encouraging and the currency stabilisation also bodes well. We see little threat to our 5% growth estimate for FY10.

US – strong momentum: US business continues to be on a strong wicket. DRL launched Nateglinide last week with shared 180-day exclusivity and it could contribute Rs.1 to FY10 reported EPS (~ 2.5% upside). DRL plans to launch 10-12 products by the end of FY10 which would further add to sales momentum. Potential Omeprazole mg and Fondaparinux launch in 3Q FY10 will definitely be a game-changer as these are multi-year opportunities that would help build scale in the US business. We see upside risk to our 26% growth forecast for FY10.

Germany – a bearable issue: While the AOK tender products are showing substantial volume growth, loss of share in non-AOK products could be an issue. We currently model a 20% YoY decline for FY10 and there could be some downside to these estimates. Germany contributes ~ 10% to total sales with much lower EBITDA contribution & hence is not a major swing factor anymore.

Earnings and target price revision

No change

Price catalyst

- 12-month price target: Rs920.00 based on a Sum of Parts methodology.
- Catalyst: 1) Fondaparinux approval 2) Quarterly results

Action and recommendation

GSK deal for emerging markets, Biologics and innovative pipeline are all option values which would unfold over the medium term. We believe the next trigger for DRL could be Fonda approval by Nov-09 which should lead to a further re-rating. Other potential limited competition opportunities (Allegra D24 & Lotrel) in early 2010 could further add fuel to the fire. Adjusting for exclusivity, DRRD is currently trading at ~16x FY3/11E earnings. DRRD looks even better (14.5x FY3/11E earnings) if we look at the earnings power excluding amortisation of acquired intangibles.

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Dr. Reddy's Laboratories (DRRD IN, Outperform, Target price: Rs920.00)

Quarterly Results					Profit & Loss						
		4Q/09A	1Q/10E	2Q/10E	3Q/10E		2009A	2010E	2011E	2012E	
Revenue	m	15,560	15,487	18,854	16,161	Revenue	m	62,240	67,336	75,420	84,312
Gross Profit	m	9,021	7,407	8,754	7,744	Gross Profit	m	31,100	33,668	37,710	42,156
Cost of Goods Sold	m	6,539	8,080	10,100	8,417	Cost of Goods Sold	m	31,140	33,668	37,710	42,156
EBITDA	m	3,416	2,781	3,566	2,517	EBITDA	m	10,642	12,931	15,110	16,888
Depreciation	m	578	751	751	751	Depreciation	m	2,310	3,003	3,432	3,761
Amortisation of Goodwill	m	0	0	0	0	Amortisation of Goodwill	m	0	0	0	0
Other Amortisation	m	376	450	450	450	Other Amortisation	m	1,504	1,800	1,800	1,800
EBIT	m	2,463	1,580	2,365	1,316	EBIT	m	6,828	8,128	9,878	11,326
Net Interest Income	m	-138	-100	-100	-100	Net Interest Income	m	-552	-400	100	600
Associates	m	6	9	9	9	Associates	m	24	35	45	55
Exceptionals	m	-2,574	717	717	717	Exceptionals	m	-10,296	2,868	2,686	2,262
Forex Gains / Losses	m	0	0	0	0	Forex Gains / Losses	m	0	0	0	0
Other Pre-Tax Income	m	0	0	0	0	Other Pre-Tax Income	m	0	0	0	0
Pre-Tax Profit	m	-243	2,206	2,991	1,942	Pre-Tax Profit	m	-3,996	10,632	12,709	14,243
Tax Expense	m	-293	-439	-465	-425	Tax Expense	m	-1,172	-1,807	-2,161	-2,421
Net Profit	m	-536	1,767	2,526	1,517	Net Profit	m	-5,168	8,824	10,549	11,822
Minority Interests	m	0	0	0	0	Minority Interests	m	0	0	0	0
Reported Earnings	m	-536	1,767	2,526	1,517	Reported Earnings	m	-5,168	8,824	10,549	11,822
Adjusted Earnings	m	2,037	1,172	1,931	921	Adjusted Earnings	m	5,125	6,444	8,319	9,944
EPS (rep)		-3.19	10.50	15.01	9.01	EPS (rep)		-30.70	52.42	62.66	70.22
EPS (adj)		12.10	6.96	11.47	5.47	EPS (adj)		30.44	38.27	49.42	59.07
EPS Growth yoy (adj)	%	-6.7	32.7	21.8	49.0	EPS Growth (adj)	%	-20.7	25.7	29.1	19.5
						PE (rep)	x	nmf	15.9	13.3	11.9
						PE (adj)	x	27.4	21.8	16.9	14.1
EBITDA Margin	%	22.0	18.0	18.9	15.6	Total DPS		4.38	4.82	5.30	5.83
EBIT Margin	%	15.8	10.2	12.5	8.1	Total Div Yield	%	0.5	0.6	0.6	0.7
Earnings Split	%	39.7	18.2	30.0	14.3	Weighted Average Shares	m	168	168	168	168
Revenue Growth	%	24.5	8.2	8.2	8.2	Period End Shares	m	168	168	168	168
EBIT Growth	%	27.6	20.7	17.6	26.1						
Profit and Loss Ratios					Cashflow Analysis						
		2009A	2010E	2011E	2012E		2009A	2010E	2011E	2012E	
Revenue Growth	%	24.5	8.2	12.0	11.8	EBITDA	m	15,574	15,799	17,796	19,150
EBITDA Growth	%	20.8	21.5	16.9	11.8	Tax Paid	m	-2,791	-1,807	-2,161	-2,421
EBIT Growth	%	25.3	19.0	21.5	14.7	Chgs in Working Cap	m	-8,267	2,909	-724	-1,486
Gross Profit Margin	%	50.0	50.0	50.0	50.0	Net Interest Paid	m	-757	-400	100	600
EBITDA Margin	%	17.1	19.2	20.0	20.0	Other	m	-11	0	0	0
EBIT Margin	%	11.0	12.1	13.1	13.4	Operating Cashflow	m	3,748	16,501	15,011	15,842
Net Profit Margin	%	-8.3	13.1	14.0	14.0	Acquisitions	m	833	0	0	0
Payout Ratio	%	14.4	12.6	10.7	9.9	Capex	m	-4,680	-4,848	-4,902	-5,059
EV/EBITDA	x	14.5	11.9	10.2	9.1	Asset Sales	m	0	0	0	0
EV/EBIT	x	22.5	18.9	15.5	13.5	Other	m	0	0	0	0
Balance Sheet Ratios						Investing Cashflow	m	-3,847	-4,848	-4,902	-5,059
ROE	%	11.5	14.0	15.2	15.3	Dividend (Ordinary)	m	-738	-812	-893	-982
ROA	%	8.2	10.4	12.6	12.7	Equity Raised	m	5	0	0	0
ROIC	%	16.2	12.1	15.5	17.7	Debt Movements	m	-662	0	0	0
Net Debt/Equity	%	32.3	5.5	-10.9	-23.1	Other	m	0	0	0	0
Interest Cover	x	12.4	20.3	nmf	nmf	Financing Cashflow	m	-1,395	-812	-893	-982
Price/Book	x	3.3	2.8	2.4	2.0	Net Chg in Cash/Debt	m	-1,722	10,841	9,216	9,801
Book Value per Share		249.7	297.3	354.7	419.1	Free Cashflow	m	-932	11,653	10,109	10,783
					Balance Sheet						
		2009A	2010E	2011E	2012E		2009A	2010E	2011E	2012E	
Cash	m	6,126	0	6,483	16,283	Cash	m	6,126	0	6,483	16,283
Receivables	m	14,592	9,996	10,553	11,697	Receivables	m	14,592	9,996	10,553	11,697
Inventories	m	13,226	16,311	17,220	19,086	Inventories	m	13,226	16,311	17,220	19,086
Investments	m	0	0	0	0	Investments	m	0	0	0	0
Fixed Assets	m	20,882	20,927	20,598	20,095	Fixed Assets	m	20,882	20,927	20,598	20,095
Intangibles	m	22,179	22,179	22,179	22,179	Intangibles	m	22,179	22,179	22,179	22,179
Other Assets	m	4,896	5,316	5,661	6,334	Other Assets	m	4,896	5,316	5,661	6,334
Total Assets	m	81,901	74,729	82,694	95,674	Total Assets	m	81,901	74,729	82,694	95,674
Payables	m	5,987	7,951	8,394	9,304	Payables	m	5,987	7,951	8,394	9,304
Short Term Debt	m	9,569	2,734	0	0	Short Term Debt	m	9,569	2,734	0	0
Long Term Debt	m	10,132	0	0	0	Long Term Debt	m	10,132	0	0	0
Provisions	m	3,411	3,411	3,411	3,411	Provisions	m	3,411	3,411	3,411	3,411
Other Liabilities	m	10,757	10,576	11,176	12,406	Other Liabilities	m	10,757	10,576	11,176	12,406
Total Liabilities	m	39,856	24,671	22,981	25,121	Total Liabilities	m	39,856	24,671	22,981	25,121
Shareholders' Funds	m	42,045	50,057	59,713	70,553	Shareholders' Funds	m	42,045	50,057	59,713	70,553
Minority Interests	m	0	0	0	0	Minority Interests	m	0	0	0	0
Other	m	0	0	0	0	Other	m	0	0	0	0
Total S/H Equity	m	42,045	50,057	59,713	70,553	Total S/H Equity	m	42,045	50,057	59,713	70,553
Total Liab & S/H Funds	m	81,901	74,729	82,694	95,674	Total Liab & S/H Funds	m	81,901	74,729	82,694	95,674

All figures in INR unless noted.

Source: Company data, Macquarie Research, September 2009

Important disclosures:

<p>Recommendation definitions</p> <p>Macquarie - Australia/New Zealand Outperform – return >5% in excess of benchmark return Neutral – return within 5% of benchmark return Underperform – return >5% below benchmark return</p> <p>Macquarie – Asia/Europe Outperform – expected return >+10% Neutral – expected return from -10% to +10% Underperform – expected return <-10%</p> <p>Macquarie First South - South Africa Outperform – expected return >+10% Neutral – expected return from -10% to +10% Underperform – expected return <-10%</p> <p>Macquarie - Canada Outperform – return >5% in excess of benchmark return Neutral – return within 5% of benchmark return Underperform – return >5% below benchmark return</p> <p>Macquarie - USA Outperform (Buy) – return >5% in excess of benchmark return (Russell 3000) Neutral (Hold) – return within 5% of benchmark return (Russell 3000) Underperform (Sell)– return >5% below benchmark return (Russell 3000)</p> <p>Recommendations – 12 months</p> <p>Note: Quant recommendations may differ from Fundamental Analyst recommendations</p>	<p>Volatility index definition*</p> <p>This is calculated from the volatility of historical price movements.</p> <p>Very high–highest risk – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.</p> <p>High – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.</p> <p>Medium – stock should be expected to move up or down at least 30–40% in a year.</p> <p>Low–medium – stock should be expected to move up or down at least 25–30% in a year.</p> <p>Low – stock should be expected to move up or down at least 15–25% in a year.</p> <p>* Applicable to Australian/NZ/Canada stocks only</p>	<p>Financial definitions</p> <p>All "Adjusted" data items have had the following adjustments made: Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests</p> <p>EPS = adjusted net profit / <i>efpowa</i>* ROA = adjusted ebit / average total assets ROA Banks/Insurance = adjusted net profit / average total assets ROE = adjusted net profit / average shareholders funds Gross cashflow = adjusted net profit + depreciation *equivalent fully paid ordinary weighted average number of shares</p> <p>All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).</p>																																
<p>Recommendation proportions – For quarter ending 30 June 2009</p> <table border="1"> <thead> <tr> <th></th> <th>AU/NZ</th> <th>Asia</th> <th>RSA</th> <th>USA</th> <th>CA</th> <th>EUR</th> <th></th> </tr> </thead> <tbody> <tr> <td>Outperform</td> <td>40.38%</td> <td>48.53%</td> <td>40.00%</td> <td>44.02%</td> <td>57.42%</td> <td>40.20%</td> <td>(for US coverage by MCUSA, 1.54% of stocks covered are corporate advisory clients)</td> </tr> <tr> <td>Neutral</td> <td>39.25%</td> <td>17.08%</td> <td>45.00%</td> <td>37.45%</td> <td>32.90%</td> <td>39.21%</td> <td>(for US coverage by MCUSA, 1.16% of stocks covered are corporate advisory clients)</td> </tr> <tr> <td>Underperform</td> <td>20.38%</td> <td>34.40%</td> <td>15.00%</td> <td>18.53%</td> <td>9.68%</td> <td>20.59%</td> <td>(for US coverage by MCUSA, 0.77% of stocks covered are corporate advisory clients)</td> </tr> </tbody> </table>				AU/NZ	Asia	RSA	USA	CA	EUR		Outperform	40.38%	48.53%	40.00%	44.02%	57.42%	40.20%	(for US coverage by MCUSA, 1.54% of stocks covered are corporate advisory clients)	Neutral	39.25%	17.08%	45.00%	37.45%	32.90%	39.21%	(for US coverage by MCUSA, 1.16% of stocks covered are corporate advisory clients)	Underperform	20.38%	34.40%	15.00%	18.53%	9.68%	20.59%	(for US coverage by MCUSA, 0.77% of stocks covered are corporate advisory clients)
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Consumer

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Linda Huang (Taiwan) (8862) 2734 7521

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Christopher Cintavey (Japan) (813) 3512 7432
Janet Lewis (Japan) (813) 3512 7475
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Sunaina Dhanuka (Malaysia) (603) 2059 8993
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Seshadri Sen (Asia) (9122) 6653 3053
Makarim Salman (Japan) (813) 3512 7421

Media

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Alex Pomento (Philippines) (632) 857 0899

Sales

Regional Heads of Sales

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Thomas Renz (Geneva) (41) 22 818 7712
Ajay Bhatia (India) (9122) 6653 3200
Andrew Mouat (India) (9122) 6653 3200
Stanley Dunda (Indonesia) (6221) 515 1555
Jason Lee (Malaysia) (603) 2059 8888
Gino C Rojas (Philippines) (632) 857 0761
Greg Norton-Kidd (New York) (1 212) 231 2527
Luke Sullivan (New York) (1 212) 231 2507
Scot Mackie (New York) (1 212) 231 2848
Sheila Schroeder (San Francisco) (1 415) 835 1235

Oil and Gas

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Jal Irani (India) (9122) 6653 3040
Polina Diyachkina (Japan) (813) 3512 7886
Edward Ong (Malaysia) (603) 2059 8982
Sunaina Dhanuka (Malaysia) (603) 2059 8993

Pharmaceuticals

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Abhishek Singhal (India) (9122) 6653 3052
Naomi Kumagai (Japan) (813) 3512 7474

Property

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Eva Lee (China, Hong Kong) (852) 3922 3573
Chris Cheng (China, Hong Kong) (852) 3922 3581
Unmesh Sharma (India) (9122) 6653 3042
Hiroshi Okubo (Japan) (813) 3512 7433
Chang Han Joo (Korea) (822) 3705 8511
Tuck Yin Soong (Singapore) (65) 6231 2838
Elaine Cheong (Singapore) (65) 6231 2839
Corinne Jian (Taiwan) (8862) 2734 7522
Patti Tomaitrichitr (Thailand) (662) 694 7727

Resources / Metals and Mining

Andrew Dale (Asia) (852) 3922 3587
Xiao Li (China) (852) 3922 4626
YeeMan Chin (China) (852) 3922 3562
Christina Lee (Hong Kong) (852) 3922 3571
Rakesh Arora (India) (9122) 6653 3054
Adam Worthington (Indonesia) (65) 6231 2981
Polina Diyachkina (Japan) (813) 3512 7886

Technology

Patrick Yau (Hong Kong) (852) 3922 1264
Zona Chen (Hong Kong) (852) 3922 3578
Damian Thong (Japan) (813) 3512 7877
David Gibson (Japan) (813) 3512 7880
George Chang (Japan) (813) 3512 7854
Michiko Kakiya (Japan) (813) 3512 7868
Yukihiko Goto (Japan) (813) 3512 5984
Michael Bang (Korea) (822) 3705 8659
Chia-Lin Lu (Taiwan) (8862) 2734 7526
Daniel Chang (Taiwan) (8862) 2734 7516
James Chiu (Taiwan) (8862) 2734 7517
Nicholas Teo (Taiwan) (8862) 2734 7523

Telecoms

Tim Smart (Asia) (852) 3922 3565
Ramakrishna Maruvada (ASEAN) (65) 6231 2842
Bin Liu (China) (852) 3922 3634
Shubham Majumder (India) (9122) 6653 3049
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Transport & Infrastructure

Anderson Chow (Asia) (852) 3922 4773
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ES Kwak (Korea) (822) 3705 8644
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Utilities

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Commodities

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Max Layton (4420) 3037 4273
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Data Services

Andrea Clohessy (Asia) (852) 3922 4076
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Economics

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Strategy/Country

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Michael Kurtz (China) (8621) 2412 9002
Seshadri Sen (India) (9122) 6653 3053
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David Gibson (Japan) (813) 3512 7880
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Prem Jearajasingam (Malaysia) (603) 2059 8989
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Alex Pomento (Philippines) (632) 857 0899
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Daniel Chang (Taiwan) (8862) 2734 7516
Alastair Macdonald (Thailand) (662) 694 7741

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Regional Heads of Sales cont'd

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Rob Fabbro (UK/Europe) (44) 20 3037 4865
Nick Ainsworth (Generalist) (852) 3922 2010

Sales Trading

Adam Zaki (Asia) (852) 3922 2002
Mike Keen (Europe) (44) 20 3037 4905
Mona Lee (Hong Kong) (852) 3922 2085
Brendan Rake (India) (9122) 6653 3204
Stanley Dunda (Indonesia) (6221) 515 1555
Mario Argyrides (Korea) (822) 3705 8610

Sales Trading cont'd

Edward Robinson (London) (44) 20 3037 4902
Thomas Chin (Malaysia) (603) 2059 8888
Robert Risman (New York) (1 212) 231 2555
Matthew Ryan (Singapore) (65) 6231 2888
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Alternative Strategies

Convertibles - Roland Sharman (852) 3922 2095
Depository Receipts - Robert Ansell (852) 3922 2094
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Futures - Tim Smith (852) 3922 2113
Structured Products - Andrew Terlich (852) 3922 2013