



Dr. Reddy's Laboratories

STOCK INFO. BLOOMBERG
BSE Sensex: 13,617 DRRD IN
REUTERS CODE
S&P CNX: 3,928 REDY.BO

29 November 2006

Buy

Rs735

Previous Recommendation: Buy

Equity Shares (m)	153.4
52-Week Range (Rs)	877/450
1,6,12 Rel. Perf. (%)	-7/-19/5
M.Cap. (Rs b)	112.7
M.Cap. (US\$ b)	2.5

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
03/06A	24,267	1,371	8.9	579.6	82.2	5.1	6.2	2.5	5.7	86.7
03/07E*	42,149	3,822	24.9	178.7	29.5	4.5	15.2	6.9	3.2	18.6
03/07E#	58,861	6,182	40.3	61.8	18.2	4.5	15.2	6.9	3.2	18.6
03/08E*	49,414	5,286	34.5	38.3	21.3	3.9	18.2	9.0	2.7	15.5

*Excludes one-time upsides from authorized generics and FTF opportunities; # Incl one-time

ADS issue unlikely to be earnings dilutive: Dr. Reddy's Laboratories (DRRD) has recently priced its ADS at US\$16/ADS and has raised about US\$200m (not taking into consideration any over-allotment). We do not expect the ADS issue to be earnings dilutive as we have assumed the utilization of ADS proceeds for debt reduction (in the short-term). Hence, savings in interest costs will fully compensate for the equity dilution.

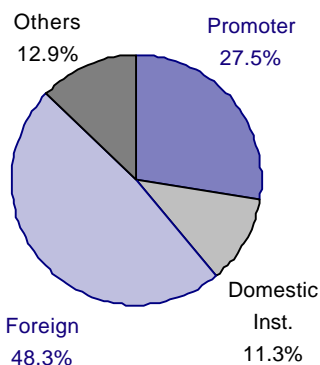
Expect strong newsflow over next two quarters: Confident of Zofran exclusivity - Management recently confirmed DRRD's eligibility of Ondansetron 180-day exclusivity but launch is contingent on US FDA approval (launch expected in December 2006). We expect one-time upside of US\$45m in revenues and incremental EPS of Rs9/share from this opportunity (not included in our estimates). We believe that there could also be some newsflows related to DRRD's other patent litigations (like Risperdal - J&J's US\$2.2b brand, Aciphex - Eisai's US\$1.2b brand, Avandia - GSK's US\$1.8b brand and Avelox - Bayer's US\$261m brand) in 2007.

NCE newsflow: DRRD expects to start Phase-III trials for Balaglitazone (DRF 2593) in early 2007 subject to favourable data on some of the tests being currently conducted. While it is too early to attach any value for this molecule, we believe that sentiments in the stock will get a boost as the molecule enters Phase-III trials.

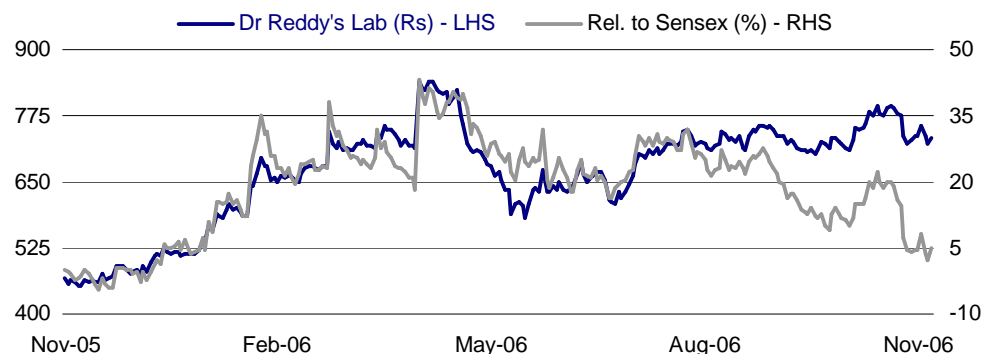
One-time/short-term opportunities on wane: As expected, competition for Allegra is likely to build up shortly as the 30-month stay periods for some of the generic players have expired. Also the authorized generics opportunity (i.e Simvastatin & Finasteride) is likely to wane from Dec-06 onwards as the 180-day exclusivity comes to an end.

Outlook: Improvement in core business coupled with large short-term opportunities like Fexofenadine, Simvastatin, Ondansetron and Finasteride will result in increased traction for FY07E. The German operations are likely to contribute positively to margins despite the recent price cuts. DRRD is currently valued at 29.5x FY07E and 21.3x FY08E earnings (excl. one-time upsides). The one-time opportunities could potentially add about Rs15/share to DRRD's FY07 earnings. We reiterate **Buy** with price target of Rs800.

SHAREHOLDING PATTERN (SEP.06)



STOCK PERFORMANCE (1 YEAR)



ADS issue unlikely to be earnings dilutive

DRRD has recently priced its ADS at US\$16/ADS and has raised about US\$200m (not taking into consideration any over-allotment). We do not expect the ADS issue to be earnings dilutive. Assuming that the entire ADS proceeds will be utilized for reducing borrowings, we present below our analysis of the impact on earnings:

ADS Issue Size (US\$ m)	200.0
Rs/US\$	45.0
ADS Issue Size (Rs m)	9,000.0
ADS Pricing - (Rs/share)	720.0
Equity Dilution (m shares)	12.5
Equity Dilution (%)	8.1
Post Issue Capital (m shares)	165.9

(RS M)	FY07E	FY08E	FY09E
Post Issue Equity Capital	829.4	829.4	829.4
Post Issue Debt	23,361.0	23,361.0	23,361.0
Interest Cost Savings (Post Tax)	116.8	469.8	469.8
Current PAT	3,880.5	5,274.6	6,162.3
PAT Post ADS Issue	3,997.3	5,744.4	6,632.1
Current EPS (Rs)	24.9	34.4	40.2
EPS Post ADS Issue (Rs)	24.1	34.6	40.0

Note: Above numbers do not assume any over-allotment in the ADS issue Source: Company/Motilal Oswal Securities

Expect strong newsflow over next two quarters

We expect strong newsflow for DRRD over the next two quarters, mainly related to its para-IV pipeline and further data points on Balaglitazone (NCE).

- Confident of Zofran exclusivity** - Management recently confirmed DRRD's eligibility of Ondansetron 180-day exclusivity but launch is contingent on US FDA

DRRD - KEY PARA-IV PRODUCTS

GENERIC INNOVATOR BRAND	2005 SALES (US\$M)	PATENT EXPIRY	CURRENT STATUS	2006/2007 NEWS-FLOW EXPECTED
Olanzapine (Eli Lilly's Zyprexa) 20mg & ODT	816	April-2011	District court decision in favor of Eli Lilly; Awaiting decision of Federal Circuit Court	Yes
Ondansetron (GSK's Zofran)	614	Dec-06, Sep 2011	Awaiting FDA approval; MOU Patent expires in December 2006	Yes
Sumatriptan (GSK's Imitrex)	836	Jun-2007, Feb-2009, 2012, 2016	Settled Para IV with GSK, awaiting FTC clearance; Authorized Generic launch in late Q4CY08 ahead of patent expiry in Feb 2009	No
Finasteride tablets 1 mg (Merck's Propecia)	138	Nov-2013	Final approval received; patent expiry in Nov 2013. Settlement with Merck for early entry launch	No
Risperidone tablets (Janssen's Risperdal)	2,218	Dec-07	District Court upheld patent validity. Appeal process under evaluation	Likely
Levetiracetam tablets (UCB's Keppra)	492	Jan-09	Sued in April 2004; Discovery in progress	No
Rosiglitazone Maleate (GSK's Avandia)	1,870	2008, 2015, 2017	Sued in September 2003 (shared exclusivity); Awaiting a trial date	No
Rabeprazole Sodium (Eisai's Aciphex)	1,198	04-Apr-2009, 2013	Sued in November 2003 (shared exclusivity) Motion for summary judgment denied on certain arguments of Teva; Trial scheduled for March 2007	Yes
Moxifloxacin HCl (Bayer's Avelox)	261	2011, 2014, 2016, 2019	Awaiting District Court decision	Yes
Rivastigmine Tartrate (Novartis' Exelon)	216	14-Aug-07, 2014	Sued in August 2004 (shared exclusivity)	Likely
Total	8,659			

Source: Company/Motilal Oswal Securities

approval (launch expected in Dec-06). Ondansetron is GSK's US\$1b Zofran brand in the US and is used as an anti-emetic. While DRRD has para IV for 4mg, 8mg & 16mg, 24mg tablets and for 4mg & 8mg ODT tablets, it enjoys the FTF status for tablets only (US\$500m market). Teva also has Para-IV and had lost in the US district court on 23 August 2004 wherein GSK's method of use patents ('628 & '789) were upheld preventing Teva's entry till Dec-2006 (including PED from Jun-06 onwards). We expect one-time upside of US\$45m in revenues and incremental EPS of Rs9/share from this opportunity (not included in our estimates) for DRRD. However, another generic player (Apotex) has recently sued the US FDA to block DRRD's exclusivity on generic Zofran. Apotex's case is likely to be heard by the US courts in early Dec-06. **A ruling favouring Apotex is likely to have an adverse impact on DRRD's stock price.**

ZOFRAN (ONDANSETRON TABLETS) 180-DAY SENSITIVITY

Brand Size (US\$m)	614	
(US\$m)	4QFY07E	1QFY08E
No. of Players - Assumed	3.0	3.0
Price Erosion (%)	70.0	70.0
DRL Market Share (%)	50.0	50.0
Sales	23.0	23.0
PAT	16.0	16.0
PAT Margin (%) - Assumed	70.0	70.0
PAT (Rs m)	741.4	741.4
Incremental EPS (Rs)	4.8	4.8

Source: Company/Motilal Oswal Securities

2. **Balaglitazone newsflow** - DRRD expects to start Phase-III trials for Balaglitazone (DRF 2593) in early 2007 subject to favourable data on some of the tests being currently conducted. It has entered into an agreement with Rheoscience, which will fund all costs associated with the Phase-III clinical trials. DRRD will

pay Rheoscience a predetermined amount for its share of the development costs. While it is too early to attach any value for this molecule, we believe that sentiments in the stock will get a boost as the molecule enters Phase-III trials. The following table gives details on DRRD's current NCE pipeline:

DRRD - NCE PIPELINE

DISEASE	MOLECULE	DEVELOPMENT STAGE	REMARKS
Atherosclerosis	RUS 3108	Phase I	Assigned to Perlecan Pharma
	DRL 16805	Pre-clinical	
Diabetes	DRF 2593	Late Phase II	Co-development with Rheoscience, Denmark
	DRL 16536	Pre-clinical	Assigned to Perlecan Pharma
Dyslipidemia	DRF 10945	Early Phase II	Assigned to Perlecan Pharma
	DRL 12424	Pre-clinical	
Obesity	DRL 11605	Phase I	Assigned to Perlecan Pharma
Rheumatoid Arthritis	DRL 15725	Pre-clinical	
Solid Tumors	DRF 1042	Phase II	Co-development with ClinTec Intl. UK

As of November 2006

Source: Company

Core business (excl one-time upsides) showing improvement

For 1HFY07, DRRD's core business (excl. acquisitions, authorized generics, Sertraline para-IV supplies and Allegra) recorded a 19% revenue growth to Rs13.6b led mainly by a 24% growth in its branded formulation business. We estimate gross margins for the core business at about 51-52% for 1HFY07 with branded formulations enjoying gross margins of about 65-70%. While we are positively enthused by the growth in the core business, we also note that DRRD's branded formulation sales in India and Russia are likely to exhibit their seasonal decline in 2H (over 1H).

1HFY07 - GP BREAKUP (RS M)

	CORE OPERATIONS	BETAPHARM	MEXICO ACQUISITION	AUTHORIZED GENERICS	GENERIC ALLEGRA	SERTRALINE API	TOTAL
Sales	13,597	4,552	2,675	11,154	1,310	800	34,088
Growth (%)	19	-	-	-			
Gross Profit	7,011	2,520	803	2,261	983	600	14,377
GPM (%)	51.6	55.4	30.0	20.3	75.0	75.0	42.2

Source: Motilal Oswal Securities

Betapharm acquisition: Extended payback, but gives strategic entry to Germany

DRRD acquired 100% stake in Betapharm Group from 3i (a private equity investor) in Mar-06 at a cost of Euro480m (~ US\$576m), which was funded through a combination of internal accruals and debt.

Betapharm recorded sales of Euro164m (~ US\$197m) in 2005 and has a portfolio of 145 products. It has about 370 employees (including 250 in the sales team). The company is the fourth largest generic player and commands a share of about 3.5% in the German market. It has a pipeline of about 20 products to be launched in the coming years.

While the acquisition cost (at 3x sales) appears on the higher side, we believe Betapharm was one of the better generic assets available in Europe given its strong positioning in Germany (4th largest generic company). Fierce competitive bidding from various generic companies has increased the acquisition cost for DRRD and extended the payback period.

DRRD is likely to leverage its product development skills and low-cost manufacturing in India to boost Betapharm's EBITDA margins. However, this outsourcing will be feasible for Betapharm's future product pipeline and hence EBITDA margin expansion may not be visible in the short-to-medium term.

Since Germany is more of a branded generic market, brand equity and doctor relationships are important determinants of success. Betapharm brings in these critical assets through a sales force of about 250. Although, DRRD has not given details on Betapharm's financial parameters, we believe it enjoys EBITDA margins of about 25% and PAT margins of about 12%-15%. Our estimates for DRRD include the impact of the Betapharm acquisition for FY07E and FY08E. We have, provided an overall indication of the upside from this acquisition in the table below:

BETAPHARM – KEY FINANCIALS (RS M)

	CY05	CY06E	CY07E
Sales	8,718.2	9,154.2	10,069.6
EBITDA	2,179.6	2,105.5	2,013.9
EBITDA Margin (%) – Assumed	25.0	23.0	20.0
Net Profit (before Interest Cost on Acquisition)	1,307.7	1,098.5	1,208.3
NPM before Interest Cost on Acquisition (%) - Assumed	15.0	12.0	12.0

Source: Company/ Motilal Oswal Securities

DRRD expects the Betapharm acquisition to be a key strategic initiative towards becoming a mid-sized global pharmaceutical company with strong presence in all key pharmaceutical markets. Through this acquisition DRRD has jumped ahead of all other Indian generic companies as far as presence in Germany is concerned.

Branded nature of German business will prevent significant margin erosion

Most of the generic companies including DRRD had cut prices (in July 2006) for some of their products in-line with the new pharmaceutical regulation in Germany. Competitors like Sandoz, Hexal and Stada had also announced price cuts effective from July 2006. The market has been forced to take a further price cut (as per the new regulations) and DRRD indicated that it will have to take an average 4% cut on about 20% of its portfolio starting 3QFY07. We believe that Betapharm's top-line growth and margins could be adversely impacted because of these price cuts. Our estimates (above) already take into account the impact of these price cuts. We believe that despite the price cuts, gross margins for DRRD in the German market will remain attractive (above 50-55%) due to the branded nature of the market. New launches (about 20 lined up for launch in the next few years) will also add incrementally to the margins.

2Q performance will not be sustained as one-time opportunities peak out

While DRRD's 2QFY07 performance was significantly above expectations led by higher traction in core business,

consolidation of acquired businesses and significant contribution from one-time/short-term opportunities, we do not expect this to sustain in the coming quarters due to:

1. Expiry of the 180-day exclusivities on generic Zocor and Proscar – will lead to significant build-up in competition for these products wef from December 2006.
2. More competition for Allegra – As the 30-month stay period for other generic players expire, we expect them to receive final US FDA approval and launch the product, thus intensifying competition for generic Allegra. This product has witnessed limited competition till date as many of the generic approvals could not get through due to the 30-month stay.

We have recently raised our estimates

We have, in our update dated Oct-06, raised our core estimates for DRRD to take into account the following:

- ✍ Better than expected performance for 2QFY07 for the core business.
- ✍ Higher sales for DRRD's branded formulations and CPS business.

REVISED FORECAST (RS M)

	FY07E			FY08E		
	REV	OLD	CHG (%)	REV	OLD	CHG (%)
Net Sales	42,149	39,787	5.9	49,385	48,059	2.8
Net Profit	3,822	3,346	14.2	5,275	5,190	1.7
EPS (Rs)	24.9	21.8	14.3	34.4	33.8	1.7

Source: Motilal Oswal Securities

Retain Buy

Over the last 2 years, DRRD has taken significant steps to revitalize its business. These have mainly been directed at reducing risks and achieving scale. The first obvious step by DRRD was to reduce costs and the risks attendant with its generic business and NCE research. This was achieved by resorting to external funding from financial investors

and is likely to reduce DRRD's SG&A expenses from as high as 35% of sales in FY05 to 28% by FY08E. R&D expenses are likely to reduce from 13% of sales to 6-7% in the same period.

DRRD's generic strategy, in the past, was skewed towards patent challenges and the company suffered substantial setbacks (omeprazole & amlodipine), which prevented the company from gaining critical mass in the global generic markets. Hence, it has resorted to inorganic growth to gain scale. It acquired Betapharm in Mar-06 for Euro480m to gain a strong foothold in the German market.

While the benefits of de-risking and cost reduction are evident from the improvement in financials, the impact of acquisitions will be visible only in the long term. Improvement in core business coupled with large opportunities like Fexofenadine, Simvastatin (authorized generic), Ondansetron and Finasteride will result in increased traction. The German operations are likely to contribute positively to margins despite the recent price cuts. DRRD is currently valued at 29.5x FY07E and 21.3x FY08E earnings (excl. one-time upsides but including the impact of acquisitions and sustainable upsides). The one-time opportunities could potentially add about Rs15/share to DRRD's FY07E EPS. We maintain **Buy** with a price target of Rs800.

COMPARATIVE VALUATIONS

		DRL	CIPLA	RANBAXY
P/E (x)	FY07E	29.5	26.7	36.0
	FY08E	21.3	22.5	21.8
P/BV (x)	FY07E	4.5	5.8	5.3
	FY08E	3.9	4.8	4.7
EV/Sales (x)	FY07E	3.2	5.0	2.7
	FY08E	2.7	4.2	2.2
EV/EBITDA (x)	FY07E	18.6	20.3	18.2
	FY08E	15.5	16.5	13.5

Source: Motilal Oswal Securities

INCOME STATEMENT					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Net Sales	19,519	24,267	42,149	49,414	54,865
Change (%)	-2.9	24.3	73.7	17.2	11.0
Total Expenditure	18,970	22,667	34,934	40,889	45,538
EBITDA	550	1,600	7,214	8,526	9,327
Change (%)	-74.4	191.1	350.9	18.2	9.4
Margin (%)	2.8	6.6	17.1	17.3	17.0
Amortization	350	420	1,656	1,350	1,240
EBIT	200	1,180	5,558	7,176	8,087
Other Income - Rec. (incl For	-93	319	-1,140	-1,100	-1,000
PBT & EO Expense	107	1,499	4,418	6,076	7,087
Change (%)	-95.8	1,300.8	194.7	37.5	16.7
Extra Ordinary Expense	0	-388	-63	0	0
PBT after EO Expense	107	1,887	4,481	6,076	7,087
Tax	-94	258	605	790	921
Tax Rate (%)	-88.1	13.7	13.5	13.0	13.0
Minority Interest	-10	0	-4	0	0
Reported PAT	211	1,629	3,880	5,286	6,166
Adjusted Net Profit	201	1,371	3,822	5,286	6,166
Change (%)	-91.9	581.1	178.7	38.3	16.7
Margin (%)	1.0	5.7	9.1	10.7	11.2

BALANCE SHEET					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Equity Share Capital	383	383	767	767	767
Reserves	20,571	21,888	24,331	28,312	32,955
Net Worth	20,953	22,272	25,098	29,079	33,722
Loans	2,827	30,995	32,361	32,361	32,361
Deferred Liabilities/Tax	373	6,229	6,229	6,229	6,229
Capital Employed	24,154	59,496	63,688	67,669	72,312
Net Fixed Assets	7,160	9,311	12,991	13,911	14,831
Investments	1,487	1,238	1,238	1,238	1,238
Goodwill/Intangible Assets	2,588	33,669	33,669	33,669	33,669
Curr. Assets	17,816	24,377	27,381	32,440	37,662
Inventory	3,500	6,895	6,322	7,412	8,230
Account Receivables	3,609	5,054	7,797	9,142	10,150
Cash and Bank Balance	9,288	3,713	9,784	11,809	14,756
Others	1,419	8,715	3,477	4,077	4,526
Curr. Liability & Prov.	4,898	9,098	11,591	13,589	15,088
Account Payables	1,555	3,791	10,537	12,354	13,716
Other Current Liabilities	3,343	5,307	1,054	1,235	1,372
Net Current Assets	12,918	15,278	15,790	18,851	22,574
Appl. of Funds	24,154	59,496	63,688	67,669	72,312

E: MOST Estimates * As per US GAAP

Above estimates do not account for the recent ADS issue as the final over-allotment figures are not yet available; refer page 2 for ADS sensitivity

RATIOS					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Basic (Rs)					
EPS	1.3	8.9	24.9	34.5	40.2
Cash EPS	3.6	11.7	35.7	43.3	48.3
BV/Share	136.9	145.2	163.6	189.6	219.8
DPS	2.5	2.5	3.2	4.3	5.0
Payout (%)	216.7	319	29.7	28.2	28.2
Valuation (x)					
P/E		82.2	29.5	21.3	18.3
Cash P/E		62.9	20.6	17.0	15.2
P/BV		5.1	4.5	3.9	3.3
EV/Sales		5.7	3.2	2.7	2.4
EV/EBITDA		86.7	18.6	15.5	13.8
Dividend Yield (%)		0.3	0.4	0.6	0.7
Return Ratios (%)					
RoE	1.0	6.2	15.2	18.2	18.3
RoCE	0.4	2.5	6.9	9.0	9.8
Working Capital Ratios					
Asset Turnover (x)	0.8	0.4	0.7	0.7	0.8
Debtor (Days)	67	76	68	68	68
Inventory (Days)	65	104	55	55	55
Working Capital (Days)	68	174	52	52	52
Leverage Ratio					
Current Ratio (x)	3.6	2.7	2.4	2.4	2.5
Debt/Equity (x)	0.1	14	13	1.1	1.0

* Adjusted for bonus issue

CASH FLOW STATEMENT					
(Rs Million)					
Y/E MARCH	2005	2006	2007E	2008E	2009E
Oper. Profit/(Loss) before Tax	550	1,600	7,214	8,526	9,327
Interest/Dividends Recd.	-93	319	-1,140	-1,100	-1,000
Direct Taxes Paid	94	-258	-605	-790	-921
(Inc)/Dec in WC	902	-7,935	5,559	-1,035	-777
CF from Operations	1,454	-6,274	11,029	5,601	6,629
EO Expense	0	-388	-63	0	0
CF from Operating incl	1,454	-5,886	11,092	5,601	6,629
(inc)/dec in FA	-1,012	-33,652	-5,336	-2,270	-2,160
(Pur)/Sale of Investments	2,892	250	0	0	0
CF from Investments	1,880	-33,402	-5,336	-2,270	-2,160
Issue of Shares	139	127	81	183	213
(Inc)/Dec in Debt	1,865	34,024	1,366	0	0
Other Items	10	0	0	0	0
Dividend Paid	-436	-437	-1,135	-1,488	-1,736
CF from Fin. Activity	1,578	33,714	311	-1,305	-1,523
Inc/Dec of Cash	4,912	-5,575	6,067	2,025	2,947
Add: Beginning Balance	4,376	9,288	3,713	9,784	11,809
Closing Balance	9,288	3,713	9,780	11,809	14,756

Note: Reported cashflow differs due to acquisition

N O T E S

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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

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