

Company Flash

22 May 2007 | 5 pages

Dr Reddy (REDY.BO)

Buy: Avandia Concerns – Possible Implications

- Avandia cardiovascular (CV) safety questioned** — A paper in the New England Journal of Medicine concludes that Avandia treatment was associated with a significant (30-40%) increased risk of heart attack and an increase in the risk of death from CV events that has borderline significance. While there are possible implications for DRL, they are not material enough to change our rating.
- May not be too serious** — Our US analyst, Kevin Wilson, who covers GSK Plc believes that the study has significant limitations including pooling of data from trials not originally intended to explore CV outcomes, absence of central adjudication of CV outcomes in most trials and unavailability of definitions of heart attacks. Besides, GSK has provided an unpublished interim analysis of the RECORD study of CV outcomes with Avandia to the FDA which provides contradictory evidence, according to FDA. Pending analyses, and with no specific risk, FDA has not asked GSK to take any action.
- DRL is FTF on Avandia** — DRL believes it has a first to file position in its patent challenge on Avandia and enjoys shared exclusivity. Avandia has annual sales of c.US\$2bn in the US, and is a potentially large opportunity for DRL, if it prevails in the litigation. As such, any erosion in Avandia's franchise or a global withdrawal would have an adverse impact on DRL.
- Will all 'glitazones' be affected?** — The other question is whether the problems apply only to Avandia or other drugs using the same pharmacological mechanism (glitazones). If yes, this may include DRL's balaglitazone, which is stated to enter phase III clinical trials over the next year. Our price target includes an option value of Rs6/share built in for balaglitazone.

Buy/Medium Risk	1M
Price (22 May 07)	Rs661.00
Target price	Rs803.00
Expected share price return	21.5%
Expected dividend yield	0.6%
Expected total return	22.1%
Market Cap	Rs110,990M US\$2,754M

Statistical Abstract

Year to	Net Profit	Diluted EPS	EPS growth	P/E	P/B	ROE	Yield
31 Mar	(RsM)	(Rs)	(%)	(x)	(x)	(%)	(%)
2006A	929	12.11	337.6	54.6	2.3	4.3	0.5
2007A	9,328	55.63	359.2	11.9	2.7	29.4	0.6
2008E	5,799	34.58	-37.8	19.1	2.4	13.3	0.7
2009E	7,376	43.99	27.2	15.0	2.1	15.0	0.7
2010E	8,605	51.32	16.7	12.9	1.8	15.2	0.7

Source: Powered by dataCentral

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See Appendix A-1 for Analyst Certification and important disclosures.

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Dr Reddy

Company description

DRL is a leading pharma company in India, with one of the best R&D pipelines. It focuses on value addition by increasing the share of branded formulations and generics exports to regulated markets. After starting as a bulk-drugs player in 1984, it has moved up the value chain and is aiming to become an innovator company. In generics, it is trying to increase the share of sales from regulated markets to boost overall profitability. As part of its inorganic growth strategy, it acquired Betapharm in Germany and is looking at smaller deals going forward.

Investment thesis

We rate DRL Buy/Medium Risk with a target price of Rs803 / share. We believe the company has evolved a business model that is among the best placed to tackle the changing dynamics of the industry. A right mix of near term growth drivers and investment for longer term sustainability of growth make DRL one of the best plays in the Indian pharma industry, in our view. Over the last few quarters, a slew of one time opportunities and inorganic initiatives have masked strong growth in the core base business. We expect this to become visible over the next few quarters and provide support to valuations. At the same time, DRL's presence in patent challenges and drug discovery implies the potential for positive surprises to earnings and valuations.

Valuation

Valuing DRL is a challenge as it has a high exposure to patent challenges and NCE research, where costs are front ended and returns likely to come through in future. As such, a pure P/E based approach would be insufficient and we use sum-of-the-parts valuation approach. We use a target multiple of 20x to value sector leaders, which is at a premium of about 40% to the broad market and is justified given that the sector is IPR driven and has the potential for significant earnings growth. At 20x June'08E earnings, we value DRL's base business at Rs703/ share. We value DRL's Para IV pipeline and drug discovery efforts separately at Rs31/share. For patent challenges we use a success probability of 20% and a discounted cash flow (discount factor 15%) for the opportunities being targeted over the next few years. We maintain Rs68/share value for DRL's new drug discovery efforts. Together, these values give us a target price of Rs803.

Risks

We rate the DRL Medium Risk in recognition of the steady growth of the base business and the longer-term potential for cash flows from research-based opportunities. The downside risks to our target price include: (1) DRL's ramp-up in sales and distribution in the US market entails large investments; (2) Patent challenges are win-lose situations and often cause volatile stock price movements; and (3) The pricing pressure in Betapharm could be more acute and longer term than we have built in currently.

Appendix A-1

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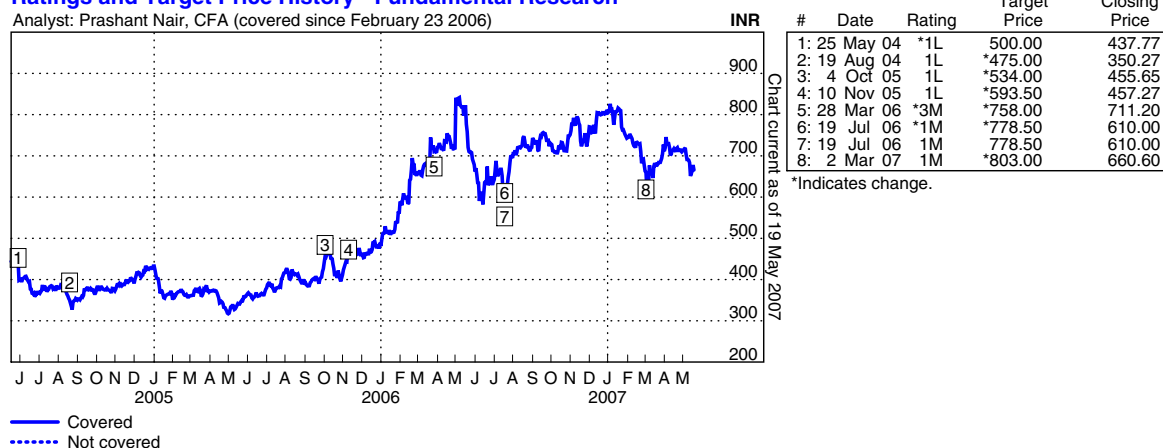
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Ratings and Target Price History - Fundamental Research

Analyst: Prashant Nair, CFA (covered since February 23 2006)



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