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JM Morgan Stanley Securities Private Limited+

Sameer Baisiwala, CFA
Sameer.Baisiwala@morganstanley.com
+91 22 2209 7830

Asish Chhabra
Asish.Chhabra@morganstanley.com
+91 22 2209 7967

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Stock Rating
Overweight

Industry View
Attractive

Dr. Reddy's Lab

F07 Should Turn Out Excellent

What's Changed	
Price Target	**Rs1,477.00 to Rs1,584.00**
ADR Price Target	**$33.00 to $35.90**
EPS F07E	**Up 11% to 74.4**

We reiterate our Overweight rating on Dr Reddy's Lab and continue to position it as a 'surprise stock' for 2006. We have raised our price target to Rs1,584, implying 17% upside from current levels, and our F07 EPS by 11% to Rs74.4 (ahead of consensus).

Sharp earnings ramp in F07E. Improving (and now profitable) base business and several major launches in the US (Allegra, Proscar, Zocor and Zofran) and gradual build-up of IPR (NCE progress in clinicals) underpin our rating.

Balaglitazone carcinogenicity studies results were satisfactory and the drug could progress to Phase III studies in the latter part of F07 for US/EU NDA filing. This could be a mid-term valuation driver.

Major earnings drivers for the US market, specifically Zocor, Zofran and Proscar each with 180 days exclusivity, are shaping up well. Importantly, according to management, there is a likelihood that Teva/Ranbaxy will launch generic Zocor by end-June (though FDA's appeal is pending). Zofran exclusivity in Dec 06 looks quite certain, in our view.

German price cuts could have a neutral impact due to the ban on discounts, according to management.

Management offered no comments on Plavix settlement. We believe that DRL/Sanofi talks could be subject to the Apotex deal being cleared by FTC. The company was silent on the launch prospects of generic Propecia in June 06 (where we believe DRL is 'first to file'), which could hint to better economics for Merck Authorised Generic deal.

Key Ratios and Statistics

Reuters: REDY.BO Bloomberg: DRRD IN ADR: RDY.N

India Pharmaceuticals	
Price target	Rs1,584.00
Shr price, close (May 31, 2006)	Rs1,357.40
Mkt cap, curr (mn)	Rs103,863
52-Week Range	Rs1,916.60-693.05
Sh out, basic, curr (mn)	77
EV, curr (mn)	Rs96,693
Net debt/cap (06) (%)	(47.9)
ROE (06) (%)	11.8
Sh out, basic, per-end (06) (mn)	77
S'hldr eqty (06) (mn)	Rs22,139
RNOA (06) (%)	8.9

Fiscal Year (Mar)	2005	2006e	2007e	2008e
ModelWare EPS (Rs)*	2.76	31.28a	74.36	61.36
Prior ModelWare EPS (Rs)	-	-	67.14	61.37
EPS, basic, rpt'd (Rs)	2.76	31.28a	74.36	61.36
Prior EPS, basic, rpt'd (Rs)	-	-	67.14	61.37
Rev, net (Rs mn)	19,472	22,135a	28,877	29,424
ModelWare net inc (Rs mn)	211	2,393a	5,690	4,695
P/E	268.0	45.4a	18.3	22.1
P/BV	2.8	4.9a	3.8	3.4
EV/EBITDA	38.5	31.7a	13.3	15.7
Div yld (%)	0.7	0.5a	0.7	0.8

* = Please see explanation of Morgan Stanley ModelWare later in this note.
a = Actual company reported data
e = Morgan Stanley Research estimates

Financial Summary

Income Statement

(Rs million)	2005	2006	2007E	2008E
Gross Revenues	**19,472**	**22,135**	**28,877**	**29,424**
Cost of Goods Sold	9,386	10,879	12,541	14,266
Gross Profit	10,086	11,256	16,335	15,157
S, G & A expenses	6,810	7,313	8,115	8,521
R & D expenses	2,803	1,760	2,342	2,142
Amortization Expenses	350	289	290	291
Forex (gain)/losses	489	(100)	(100)	(100)
Operating Expenses	19,838	20,140	23,188	25,119
Operating profit	**(366)**	**1,995**	**5,689**	**4,304**
Equity in Loss Affiliates	(58)	40	40	40
Other income	532	538	737	1,004
Pre-tax profit	**108**	**2,573**	**6,466**	**5,348**
Taxation	(94)	180	776	652
Minority Interest	9	0	0	0
Net profit	**211**	**2,393**	**5,690**	**4,695**
Effective Tax Rate (%)	*-87.0*	*7.0*	*12.0*	*12.2*
EPS	*2.8*	*31.3*	*74.4*	*61.4*
DPS	*5.0*	*7.0*	*10.0*	*11.0*

Balance Sheet

(Rs million)	2005	2006	2007E	2008E
Total Liabilities	**21,602**	**23,405**	**28,330**	**32,183**
Equity share capital	383	383	383	383
Additional paid in capital	10,085	10,085	10,085	10,085
Retained Earnings	9,827	11,630	16,555	20,409
Total Stockholder's equity	20,336	22,139	27,064	30,918
Total Long term Liab	1,166	1,166	1,166	1,166
Total Short term Liab	100	100	100	100
Total Assets	**21,602**	**23,405**	**28,330**	**32,183**
Net block	6,685	6,754	6,735	6,630
Total net fixed assets	6,685	6,754	6,735	6,630
Investments	305	355	405	455
Intangible assets	2,135	1,846	1,557	1,266
Cash & cash Eqv	6,282	7,315	10,763	14,572
Current Assets	9,078	10,474	12,553	13,308
Inventories	3,086	3,726	4,295	4,886
Receivables	4,268	4,852	6,171	6,127
Other current assets	1,725	1,897	2,087	2,296
Less : Curr Liab	2,971	3,427	3,771	4,136
Net Current Assets	6,107	7,048	8,782	9,172
Net Debt	(6,132)	(7,165)	(10,613)	(14,422)

Cash Flow

(Rs million)	2005	2006	2007E	2008E
Profit after tax	211	2,393	5,690	4,695
Net change in Working capital	(57)	(941)	(1,734)	(390)
Net cash from operations	**1,398**	**2,723**	**5,314**	**5,751**
Capital expenditure	(1,750)	(1,050)	(1,050)	(1,050)
Sale of investments	(50)	(50)	(50)	(50)
Intangible/Related Party/Other assets	0	0	0	0
Net cash from investing	**(1,800)**	**(1,100)**	**(1,100)**	**(1,100)**
Issue of shares	(0)	(0)	(0)	(0)
Dividends paid including dividend tax	(422)	(590)	(765)	(842)
Net cash from financing	**(422)**	**(590)**	**(765)**	**(842)**
Net Inc/(Dec) in Debt	823	(1,032)	(3,448)	(3,809)
Opening Debt	(6,955)	(6,132)	(7,165)	(10,613)
Closing Debt	(6,132)	(7,165)	(10,613)	(14,422)

Ratios

	2005	2006	2007E	2008E
Profitability Ratios				
Gross Margin (%)	51.8	50.9	56.6	51.5
Operating Margin (%)	-1.9	9.0	19.7	14.6
Pre-tax Margin (%)	0.6	11.6	22.4	18.2
Net Margin (Excl Extraordinary Items) (%)	1.1	10.8	19.7	16.0
Valuation Ratios				
P/E	492.2	45.4	18.3	22.1
P/BV	5.1	4.7	3.8	3.4
ROE (%)	1.0	11.3	23.1	16.2
ROCE (%)	0.5	11.4	25.0	17.7
EV/EBITDA	588.7	38.2	14.5	16.9
Leverage Ratios				
Net Debt/Equity	-0.30	-0.32	-0.39	-0.47
Total Debt/Equity	0.01	0.01	0.01	0.00
Turnover Ratios				
Inventory (days of net sales)	120	125	125	125
Receivables (days of net sales)	80	80	78	76
Cash cycle (days of net sales)	200	205	203	201
Net working capital (x net sales)	114	108	100	111

Source: Company data, Morgan Stanley Research

Investment Case

Summary & Conclusions - Overweight

We reiterate our Overweight rating on Dr Reddy's Lab and continue to position it as 'surprise stock' for 2006.

Sharp earnings ramp up in F07e. Improving base business (now turned profitable), several earnings catalysts (Allegra, Zocor, Proscar and Zofran) in the pipeline, and gradual Intellectual Property build up (NCE progression in clinical trials) underpin our recommendation. Our new price target of Rs1,584 implies 17% upside from current levels.

We raise our F07E EPS by 11% to Rs74.4 to include the forecast upside from Zocor exclusivity (as Authorised Generic) in our model.

Earnings Call Highlights

- **Management view.** The company is excited about F07 growth prospects and views this as an 'inflection year'.

- **Qualitative F07 guidance.** DRL expects momentum in sales to continue — domestic business will exceed market growth rate, Russia/CIS business will maintain high growth trajectory, several key drug launches in US generic market, custom Pharma services to hit $100 million target in 12 months. In terms of profitability, the base business will unlock margins due to scale benefits (two acquisitions and organic growth) and high potential from US drug launches will further drive up earnings. Gross margin in Betapharm is closer to (high) DRL's brand formulation business level, whereas for Roche's CPS (custom pharmaceutical services) business is closer to (low) DRL's bulk active business. The effective tax rate will be close to 10% (driven by bulk active and authorized generic businesses).

- **Investments in longer term growth initiatives will continue.** The company plans $100 million capex in manufacturing facilities. It will continue to pursue low-risk NCE research strategy of sharing cost with its partners/alliances. DRL targets to acquire a couple of dermatology brands in the US in F07 as a launching pad for its in house pipeline (could take 3–4 years to launch).

- **German price cuts.** The company is evaluating its options on a product by product basis but estimates that the price cuts will be made up by the (ban on) discounts. Hence, the net effect on the bottom line could be neutral, according to the management.

- **NCE pipeline.** DRL is satisfied with the recently completed carcinogenicity studies for its lead compound, Balaglitazone. The company is conducting some balance Phase I studies, after which, it will take the molecule to Phase III studies (Phase II is over) towards the latter part of F07 for US/EU NDA filing.

- **Plavix settlement with Sanofi.** Management offered no comments. We believe that its discussion with the innovator might be pending FTC comments/clearance on the Apotex deal. We have not included any upside from this deal in our numbers.

- **Zocor exclusivity.** Management appeared confident about the prospects of Ranbaxy/Teva launch of the generic with 180 days exclusivity, which will catalyse the launch of authorized generic version by DRL. The company believes that this could happen towards the end of June despite the appeal filed by the USFDA.

- **Fexofenadine.** DRL believes that its current market share of 2%, as reported by IMS, lags the actual

Company Description

Dr. Reddy's Laboratories Ltd. manufactures and markets pharmaceutical products. The company has three bulk-drug manufacturing plants and one formulation manufacturing plant. It exports to the UK, Switzerland, Germany, Spain, Russia and the Netherlands.

Industry View: Attractive

Earnings momentum and IPR build-up are the reasons.

MSCI Country: India

Asia Strategist's Recommended Weight: 1.4%
MSCI Asia/Pac All Country Ex Jp Weight: 6.0%

figure (which is higher, according to the management). Also, the company is focused on the profitability and, therefore, hasn't lowered prices meaningfully to gain share. The additional competition may not get launched in June.

- **Propecia.** The company did not offer comments whether it would launch the generic product in June 2006.
- **I Venture deal for generic R&D** might not be renewed for a second set of ANDA filings; i.e., beyond F06. The first set includes drugs filed in two years of F2005-06.
- **Regulatory filings.** DRL has 49 ANDAs (Abbreviated New Drug Application) pending USFDA approval and has done a cumulative 81 DMF (Drug Master File) submissions and 25 EDMF (European DMF) submissions.

Key Takeaways from F4Q06 Results

We have detailed F4Q06 results in Exhibits 2 and 3. Importantly, the fourth quarter numbers include 28 days data (March 2 onwards) of Betapharm and 3 months data of Roche's CPS business, both acquired by DRL over the last six months. According to management, the F4Q06 quarter number cannot be extrapolated to the full year due to partial inclusion of sales/costs, a few one-time acquisition related expenses and the 'not regular' business circumstances (due to management change over, we believe). Therefore, we have done a rather brief analysis of the quarter performance below.

Overall sales were up 29% (excluding the impact of Betapharm and Roche's CPS business), driven by the all-round performance: domestic formulations (also helped by low base due to VAT issues last year), bulk active business (terbinafine, sertraline and montelukast), and international formulations. The EU generic business revenue (excluding Betapharm) declined to Rs325 million from Rs410 million last year due to price declines (now stabilized) for omeprazole and amlodipne. The North American generic business revenue was up 57% to Rs544 million driven by the new launches, zonisamide and glimipiride.

Gross margins compressed by 6 percentage points due to lower contribution from international formulation business and full quarter impact of lower margin Roche's CPS business. The company reported net losses of Rs236 million versus Rs520 million losses last year.

Valuations and Price Target

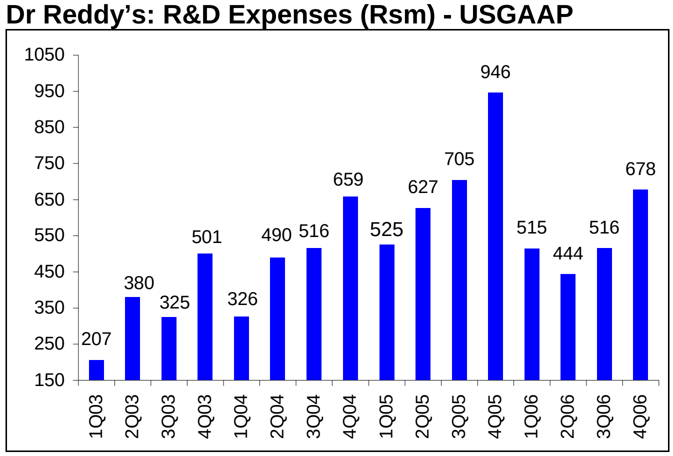
The stock trades at 18 times our F2007 earnings estimate, a 15% discount to the sector. We believe that the current valuation is not factoring the near term earnings ramp for Dr Reddy's Lab.

We increase our price target to Rs1,584, implying 17% upside potential from current levels. We arrive at our new price target by applying a target earnings multiple of 21.3 (in line with the sector target P/E of 21x) to our F2007E EPS estimate of Rs74.4. The increase in our price target comes largely from our F2007 earnings upgrade and a marginal cut in the target P/E multiple (in line with the decline in sector valuations). We believe Dr Reddy's should trade in line with the industry P/E given the significant, but relatively shorter earnings growth period for three key products (6-9 month window for each generic opportunity – Allegra, Zofran and Zocor) and gradual IPR optionality.

The key downside risks to our price target are a loss of Zofran/Zocor exclusivities, lower-than expected market share in the US for its key products, failure of drugs in the research pipeline, and slower-than-expected recovery in the base business.

Exhibit 1

Dr Reddy's: R&D Expenses (Rsm) - USGAAP



Source: Company data, Morgan Stanley Research

Exhibit 2

Dr. Reddy's: F4Q06 (As Per US GAAP)

(Rs mn)	F4Q06	F4Q05	%chg	F3Q06	%chg	F2006	F2005	%chg
(period ending)	31-Mar-06	31-Mar-05	YoY	31-Dec-05	QoQ	31-Mar-06	31-Mar-05	YoY
Total Sales	**6974**	**4252**	**64.0%**	**5902**	**18.2%**	**24267**	**19472**	**24.6%**
Total Expenses	7173	5041	42.3%	5568	28.8%	22825	19838	15.1%
Cost of Revenues	4036	2218	82.0%	2911	38.6%	12417	9386	32.3%
SG&A Expenses	2279	1721	32.4%	2026	12.5%	8029	6810	17.9%
R&D Expenses	678	946	-28.3%	516	31.4%	2153	2803	-23.2%
Amortization Expenses	162	87	86.2%	86	88.4%	420	350	20.0%
Other operating (income)/Expense			NM		NM	(320)		NM
Forex Loss (Gains)	18	69	-73.9%	29	-37.9%	126	489	-74.2%
Operating Profit	**121**	**(789)**	**NM**	**334**	**-63.8%**	**1442**	**(366)**	**NM**
Equity loss of affiliates	48	16	200.0%	9	433.3%	(88)	(58)	NM
Other Income (net) (%)	(369)	160	NM	591	NM	534	532	0.4
PBT (%)	**(296)**	**(645)**	**NM**	**916**	**NM**	**1887**	**107**	**1663.6**
Tax	(62)	(127)	NM	287	NM	258	(94)	NM
Minority Interest	(1)	(1)	NM	1	NM	0	10	NM
PAT (%)	**(236)**	**(520)**	**NM**	**628**	**NM**	**1629**	**211**	**672.0**
OPM (%)	*1.7*	*-18.6*	*20.3*	*5.7*	*-3.9*	*5.9*	*-1.9*	*7.8*
NPM (%)	*-3.4*	*-12.2*	*8.8*	*10.6*	*-14.0*	*6.7*	*1.1*	*5.6*
Effective Tax Rate (%)	*NM*	*NM*	*NM*	*31.3*	*NM*	*13.7*	*-87.9%*	*101.5%*

Source: Company data, Morgan Stanley Research

Exhibit 3

Dr. Reddy's: F4Q06 Revenue Mix (As Per US GAAP)

(Rs mn)	F4Q06	F4Q05	%chg	Revenue Share	F2006	F2005	%chg	Revenue Share
Domestic	**1815**	**1209**	**50.1%**	**26.0%**	**7820**	**6332**	**23.5%**	**32.2%**
Formulation	1269	832	52.5%	18.2%	5524	4360	26.7%	22.8%
Bulk	546	377	44.8%	7.8%	2296	1972	16.4%	9.5%
Exports	**3929**	**2818**	**39.4%**	**56.3%**	**14399**	**12012**	**19.9%**	**59.3%**
Formulation	811	680	19.3%	11.6%	4401	3463	27.1%	18.1%
Bulk	1544	1382	11.7%	22.1%	5942	4972	19.5%	24.5%
Generics*	1574	756	108.2%	22.6%	4056	3577	13.4%	16.7%
Custom Pharma Services**	**1037**	**91**	**1039.6%**	**14.9%**	**1326**	**312**	**325.0%**	**5.5%**
Emerging Businesses	164	133	23.3%	2.4%	691	527	31.1%	2.8%
Drug Discovery	0	0	NM	0.0%	0	0	NM	0.0%
Others	29	0	NM	0.4%	29	288	-89.9%	0.1%
Business-wise breakup								
Formulation	3654	2268	61.1%	52.4%	13981	11400	22.6%	57.6%
Bulk	2090	1759	18.8%	30.0%	8238	6944	18.6%	34.0%
Others	1230	224	449.1%	17.6%	2046	1127	81.5%	8.4%
Total Sales	**6974**	**4251**	**64.1%**		**24265**	**19471**	**24.6%**	

Source: Company data, Morgan Stanley Research
*Includes revenues of Rs 705 mn. from Betapharm (starting 3rd March)
**Includes revenues of Rs 805 mn. From CPS business in Mexico (Starting 31st December

Morgan Stanley
ModelWare[SM]

ModelWare is Morgan Stanley's new system for helping investors and analysts to uncover value, free from the distortions and ambiguities created by accounting data. Morgan Stanley has dissected and fundamentally redefined the components of corporate valuation, giving clients more consistent definitions, more comparable data, and more flexible analytic tools. ModelWare makes investment insights easier by making value more visible.

Past inconsistencies in financial reporting made it difficult to compare performance among companies and across sectors and regions. Even within US GAAP, flexibility complicates comparisons. And accounting standards were developed to analyze historical data, not to facilitate projections. In response, Morgan Stanley analysts spent two years reviewing our entire coverage universe of company metrics. They defined more than 2,000 general and industry-specific metrics that eliminated inconsistencies stemming from regional differences, historical precedents and accounting conventions. The team applied these metrics across also all 1900+ companies we cover, and created flexible tools and services that let analysts redefine and use the data with maximum creativity. Because ModelWare provides complete transparency, users see every component of every calculation, to choose elements or recombine them as they wish.

ModelWare EPS illustrates the approach. It represents ModelWare EPS as ModelWare net income divided by average fully diluted shares outstanding. ModelWare net income sums net operating profit after tax (NOPAT), net financial income or expense (NFE) and other income or expense. ModelWare adjusts reported net income to improve comparability across companies, sectors and regions. Among these adjustments: We exclude goodwill amortization and items deemed by analysts to be "one-time" events; we capitalize operating leases where their use is significant (e.g., in transportation and retail); and we convert inventory to FIFO accounting when LIFO costing is used. For more information on these adjustments and others, as well as additional background, please see *Morgan Stanley ModelWare (ver. 1.0): A Road Map for Investors*, by Trevor Harris and team, August 2, 2004.

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Unless otherwise stated, the individuals listed on the cover page of this report are research analysts.

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As of April 28, 2006, Morgan Stanley beneficially owned 1% or more of a class of common equity securities of the following companies covered in this report: Aventis (India), Ranbaxy Laboratories, Wockhardt Limited.

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Within the last 12 months, Morgan Stanley has received compensation for investment banking services from Ranbaxy Laboratories.

In the next 3 months, Morgan Stanley expects to receive or intends to seek compensation for investment banking services from Ranbaxy Laboratories.

Within the last 12 months, Morgan Stanley & Co. Incorporated has received compensation for products and services other than investment banking services from GlaxoSmithKline Pharma.

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Global Stock Ratings Distribution

(as of April 30, 2006)
For disclosure purposes only (in accordance with NASD and NYSE requirements), we include the category headings of Buy, Hold, and Sell alongside our ratings of Overweight, Equal-weight and Underweight. Morgan Stanley does not assign ratings of Buy, Hold or Sell to the stocks we

cover. Overweight, Equal-weight, and Underweight are not the equivalent of buy, hold, and sell but represent recommended relative weightings (see definitions below). To satisfy regulatory requirements, we correspond Overweight, our most positive stock rating, with a buy recommendation; we correspond Equal-weight and Underweight to hold and sell recommendations, respectively.

	Coverage Universe		Investment Banking Clients (IBC)		
Stock Rating Category	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight/Buy	**713**	**36%**	**261**	**41%**	**37%**
Equal-weight/Hold	**883**	**45%**	**295**	**46%**	**33%**
Underweight/Sell	**367**	**19%**	**84**	**13%**	**23%**
Total	**1,963**		**640**		

Data include common stock and ADRs currently assigned ratings. An investor's decision to buy or sell a stock should depend on individual circumstances (such as the investor's existing holdings) and other considerations. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

Analyst Stock Ratings

Overweight (O or Over) - The stock's total return is expected to exceed the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Equal-weight (E or Equal) - The stock's total return is expected to be in line with the total return of the relevant country MSCI Index, on a risk-adjusted basis over the next 12-18 months.

Underweight (U or Under) - The stock's total return is expected to be below the total return of the relevant country MSCI Index, on a risk-adjusted basis, over the next 12-18 months.

More volatile (V) - We estimate that this stock has more than a 25% chance of a price move (up or down) of more than 25% in a month, based on a quantitative assessment of historical data, or in the analyst's view, it is likely to become materially more volatile over the next 1-12 months compared with the past three years. Stocks with less than one year of trading history are automatically rated as more volatile (unless otherwise noted). We note that securities that we do not currently consider "more volatile" can still perform in that manner.

Unless otherwise specified, the time frame for price targets included in this report is 12 to 18 months.

Analyst Industry Views

Attractive (A): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be attractive vs. the relevant broad market benchmark, as indicated below.

In-Line (I): The analyst expects the performance of his or her industry coverage universe over the next 12-18 months to be in line with the relevant broad market benchmark, as indicated below.

Cautious (C): The analyst views the performance of his or her industry coverage universe over the next 12-18 months with caution vs. the relevant broad market benchmark, as indicated below.

Benchmarks for each region are as follows: North America - S&P 500; Latin America - relevant MSCI country index; Europe - MSCI Europe; Japan - TOPIX; Asia - relevant MSCI country index.

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Morgan Stanley
JM MORGAN STANLEY

The Americas
1585 Broadway
New York, NY 10036-8293
United States
Tel: +1 (1) 212 761 4000

Europe
25 Cabot Square, Canary Wharf
London E14 4QA
United Kingdom
Tel: +44 (0) 20 7 425 8000

Japan
4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008
Japan
Tel: +81 (0) 3 5424 5000

Asia/Pacific
Three Exchange Square
Central
Hong Kong
Tel: +852 2848 5200

Industry Coverage:India Pharmaceuticals

Company (Ticker)	Rating (as of)	Price (05/31/2006)
Sameer Baisiwala, CFA		
Aventis (India) (AVPH.BO)	O (07/06/2005)	Rs1688.70
Biocon Ltd (BION.BO)	U (10/24/2005)	Rs397.65
Cipla Ltd. (CIPL.BO)	U (04/13/2006)	Rs229.50
Dr. Reddy's Lab (REDY.BO)	Overweight (12/19/2005)	Rs1357.40
GlaxoSmithKline Pharma (GLAX.BO)	E (02/15/2006)	Rs1130.00
Lupin Ltd. (LUPN.BO)	U (03/31/2006)	Rs1030.90
Ranbaxy Laboratories (RANB.BO)	E (04/29/2005)	Rs411.45
Sun Pharmaceutical Industries (SUN.BO)	O (09/27/2004)	Rs805.40
Wockhardt Limited (WCKH.BO)	E (08/17/2005)	Rs360.15

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