

## DR. REDDY'S LABORATORIES

INR 1,340

*Down due to acquisitions*

ACCUMULATE

Dr Reddy's surprisingly reported a loss of INR 235 mn in Q4, against our estimate of a profit of INR 370 mn. This was primarily due to a sharp drop in gross margin because of the consolidation of its acquired plant in Mexico from Roche. This was further aggravated by price erosion in the company's existing products in the US and Europe.

We estimate a 164% growth in FY07E EPS, on the back of: (1) full year impact of acquisitions (we have assumed margins of the acquired businesses to be better than their Q4FY06 margins); (2) launch of authorized generic version of simvastatin; (3) launch of fexofenadine, which has only two other generic players; and (4) a likely upside from finesteride. However, we believe all these upsides are factored into the share price. On the other hand, there can be some upside from the settlement of the Plavix patent case (although management maintained there are no talks ongoing) or a licensing deal for its lead NCE molecule Balaglitazone. However, all these are highly uncertain.

In addition, the EPS may fall by 17% in FY08E as the benefits of authorized generic simvastatin, launched in FY07E, will get diluted in FY08E. At CMP of INR 1,340, the stock trades at a PE of 23.8x on FY07E earnings and at 28.9x on FY08E earnings. We suggest remaining on the sidelines and maintain our 'ACCUMULATE' recommendation.

\* **Mexico acquisition proves to be a severe drag on margin**

The sharp drop in gross margin from 52% for nine months of FY06 to 42% in Q4FY06 was mainly on account of the consolidation of the financials of Roche's Mexico plant that was acquired by the company. As per the company, the acquisition has a gross margin "much lower" than the average gross margin of Dr Reddy's. Although the company did not mention clearly, we fear that this unit is incurring an operating loss. Subscribing to the company's confidence on its turnaround, we have assumed 20% gross margin for this business in FY07E, although it looks ambitious.

Besides this, gross margin decrease was also owing to the lower proportion of the high margin international branded formulations and further pricing pressures on their older products in the US and European markets.

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Reuters : REDY.BO  
Bloomberg : DRRD IN

**Market Data**

52-week range (INR) : 1,754 / 503  
Share in issue (mn) : 76.6  
M cap (INR bn/USD mn) : 102.6 / 2,214.5  
Avg. Daily Vol. BSE/NSE ('000) : 318.9

**Share Holding Pattern (%)**

Promoters : 27.6  
MFs, FIs & Banks : 9.4  
FIs : 28.5  
Others : 34.5

**Financials**

| Year to March       | Q4FY06 | Q4FY05 | % change | Q3FY06 | % change | FY05   | FY06   | FY07E  |
|---------------------|--------|--------|----------|--------|----------|--------|--------|--------|
| Revenues (INR mn)   | 7,294  | 4,252  | 71.5     | 5,902  | 23.6     | 19,472 | 24,587 | 50,684 |
| EBITDA (INR mn)     | 301    | (372)  | 180.9    | 735    | 59.0     | 1,432  | 2,827  | 7,606  |
| Net profit (INR mn) | (235)  | (517)  | 54.5     | 628    | (137.4)  | 211    | 1,630  | 4,303  |
| EPS (INR)           | (3.1)  | (6.8)  | 54.5     | 8.2    | (137.4)  | 2.8    | 21.3   | 56.2   |
| PE (x)              |        |        |          |        |          | 486.2  | 62.9   | 23.8   |
| EV/EBITDA (x)       |        |        |          |        |          | 67.1   | 44.3   | 16.5   |

\* **Impending price cuts in German markets to impact Betapharm**

Q4FY06 registered 28 days of sales from Betapharm amounting to INR 705 mn. The company acknowledged the looming price cuts in the generic market owing to new government regulations. Novartis and Stada have already announced price cuts by 30-40% starting from July 1, 2006 owing to changes in the German healthcare system.

This could severely impact both sales and margins of Betapharm. We have now assumed 45% gross margin which is similar to their current gross margins in the US and other European generic markets. It is worth noting that Q4 indicates Betapharm's gross margin to be much lower than 45%.

\* **US generics – Simvastatin offers robust one-time growth in FY07E**

The US generics market may grow nine fold to USD 336 mn, of which authorized generic of simvastatin alone will contribute USD 230 mn, in FY07E. However, after the expiry of 180-day exclusivity, there will be severe price erosion and a loss of market share for Dr Reddy's. We have assumed 50% price cut and 25% market share for Dr Reddy's in the 180-day exclusivity period. Post the exclusivity period, we have assumed a 90% price cut and 20% market share. It should be noted that Dr Reddy's still does not have an ANDA approval for simvastatin. In addition, unlike Ranbaxy and Teva, its simvastatin manufacturing is not fully integrated, putting it in a weaker position post the exclusivity period. Besides simvastatin, we have assumed upsides from six new launches in FY07, which include authorized generics of finasteride and fexofenadine.

However, in FY08, all of the three main launches, viz., simvastatin, finasteride and fexofenadine, will see intense competition that may drive down sales and profitability. And, our concern is that there will be very few new product launches in FY08 to compensate this loss. Although there is visibility of only two new launches, we have assumed four new launches in FY08.

\* **Valuation**

Our main concern for Dr Reddy's has been the rather slow pace of new product introductions, both in European and US markets. This exposes the company to pricing vagaries in existing products.

The robust growth in FY07E profits by 164% is more due to one off items and EPS will fall by 17.4% in FY08E owing to a lean product pipeline. We thus believe that unless the pace of product launches increases, Dr Reddy's' earnings will remain volatile depending on one-time events.

At CMP of INR 1,340, the stock trades at a P/E of 23.8x on FY07E earnings and at 28.9x on FY08E earnings. We suggest remaining on the sidelines and maintain our '**ACCUMULATE**' rating.

(INR mn)

| Financial snapshot                 |              |              |               |              |                |               |               |               |
|------------------------------------|--------------|--------------|---------------|--------------|----------------|---------------|---------------|---------------|
| Year to March                      | Q4FY06       | Q4FY05       | Growth (%)    | Q3FY06       | Growth (%)     | FY05          | FY06          | FY07E         |
| <b>Income from operations</b>      | <b>7,294</b> | <b>4,252</b> | <b>71.5</b>   | <b>5,902</b> | <b>23.6</b>    | <b>19,472</b> | <b>24,587</b> | <b>50,684</b> |
| Cost of revenues                   | 4,036        | 1,957        | 106.2         | 2,625        | 53.8           | 8,427         | 11,578        | 29,108        |
| <b>Gross profit</b>                | <b>3,258</b> | <b>2,295</b> | <b>42.0</b>   | <b>3,277</b> | <b>(0.6)</b>   | <b>11,045</b> | <b>13,009</b> | <b>21,576</b> |
| Selling, admin. & general expenses | 2,279        | 1,721        | 32.4          | 2,026        | 12.5           | 6,810         | 8,029         | 11,386        |
| Research and development expenses  | 678          | 946          | (28.3)        | 516          | 31.4           | 2,803         | 2,153         | 2,584         |
| <b>EBITDA</b>                      | <b>301</b>   | <b>(372)</b> | <b>180.9</b>  | <b>735</b>   | <b>(59.0)</b>  | <b>1,432</b>  | <b>2,827</b>  | <b>7,606</b>  |
| Depreciation & amortization exp.   | 162          | 348          | (53.4)        | 372          | (56.5)         | 1,310         | 1,259         | 1,626         |
| Forex loss / (gain)                | 18           | 69           | (73.9)        | 29           | (37.9)         | 489           | 126           | 350           |
| Equity in loss of affiliates       | 48           | 16           | 200.0         | 9            | 433.3          | 58            | 88            | -             |
| Other expenses/ (income) net       | 369          | (160)        | 330.6         | (591)        | 162.4          | (532)         | (534)         | (500)         |
| Interest expense                   |              |              |               |              |                |               |               | 1,068         |
| <b>PBT</b>                         | <b>(296)</b> | <b>(645)</b> | <b>(54.1)</b> | <b>916</b>   | <b>(132.3)</b> | <b>107</b>    | <b>1,888</b>  | <b>5,062</b>  |
| Income tax (benefit)/ expenses     | (62)         | (127)        | 51.2          | 287          | (121.6)        | (93)          | 258           | 759           |
| Minority interest                  | 1            | (1)          | 200.0         | 1            |                | (11)          | -             | -             |
| <b>Net income</b>                  | <b>(235)</b> | <b>(517)</b> | <b>54.5</b>   | <b>628</b>   | <b>(137.4)</b> | <b>211</b>    | <b>1,630</b>  | <b>4,303</b>  |
| Diluted SOS (mn)                   | 77           | 77           |               | 77           |                | 77            | 77            | 77            |
| <b>Diluted EPS (INR)</b>           | <b>(3.1)</b> | <b>(6.8)</b> | <b>54.5</b>   | <b>8.2</b>   | <b>(137.4)</b> | <b>2.8</b>    | <b>21.3</b>   | <b>56.2</b>   |
| PE (x)                             |              |              |               |              |                | 486.2         | 62.9          | 23.8          |
| EV/EBITDA (x)                      |              |              |               |              |                | 67.1          | 44.3          | 16.5          |
| M.Cap/revenues (x)                 |              |              |               |              |                | 5.3           | 4.2           | 2.0           |
| <b>as % of net revenues</b>        |              |              |               |              |                |               |               |               |
| COGS                               | 55.3         | 46.0         |               | 44.5         |                | 43.3          | 47.1          | 57.4          |
| Total expenses                     | 96.1         | 110.4        |               | 88.0         |                | 95.2          | 89.0          | 85.7          |
| Depreciation                       | 2.2          | 8.2          |               | 6.3          |                | 6.7           | 5.1           | 3.2           |
| Tax rate                           | 20.9         | 19.7         |               | 31.3         |                | (86.9)        | 13.7          | 15.0          |
| Gross profit                       | 44.7         | 54.0         |               | 55.5         |                | 56.7          | 52.9          | 42.6          |
| EBITDA                             | 4.1          | (8.7)        |               | 12.5         |                | 7.4           | 11.5          | 15.0          |
| Net profit                         | (3.2)        | (12.2)       |               | 10.6         |                | 1.1           | 6.6           | 8.5           |

## Financial Statements

| Income statement                       |               |               |               | (INR mn)      |
|--|---------------|---------------|---------------|---------------|
| Year To March                          | FY05          | FY06          | FY07E         | FY08E         |
| <b>Income from operations</b>          | <b>19,472</b> | <b>24,587</b> | <b>50,684</b> | <b>47,224</b> |
| Total operating expenses               | 18,040        | 21,760        | 43,078        | 40,536        |
| Cost of revenues                       | 8,427         | 11,578        | 29,108        | 24,952        |
| Selling, admin and general expenses    | 6,810         | 8,029         | 11,386        | 12,278        |
| R&D cost                               | 2,803         | 2,153         | 2,584         | 3,306         |
| <b>EBITDA</b>                          | <b>1,432</b>  | <b>2,827</b>  | <b>7,606</b>  | <b>6,688</b>  |
| Depreciation and amortisation          | 1,310         | 1,259         | 1,626         | 1,690         |
| Forex loss / (gain)                    | 489           | 126           | 350           | 350           |
| Other income                           | (532)         | (534)         | (500)         | (600)         |
| Extraordinary items [expenses/(gain)]  | 58            | 88            | -             | -             |
| Interest expense                       | -             | -             | 1,068         | 1,068         |
| Profit before tax                      | 107           | 1,888         | 5,062         | 4,180         |
| Provision for tax                      | (93)          | 258           | 759           | 627           |
| <b>Profit before minority interest</b> | <b>200</b>    | <b>1,630</b>  | <b>4,303</b>  | <b>3,553</b>  |
| Minority interest & others             | (11)          | -             | -             | -             |
| <b>PAT for equity shareholders</b>     | <b>211</b>    | <b>1,630</b>  | <b>4,303</b>  | <b>3,553</b>  |

## Common size metrics- as % of net revenues

| Year To March                       | FY05 | FY06 | FY07E | FY08E |
|-------------------------------------|------|------|-------|-------|
| Cost of revenues                    | 43.3 | 47.1 | 57.4  | 52.8  |
| Selling, admin and general expenses | 35.0 | 32.7 | 22.5  | 26.0  |
| Depreciation                        | 6.7  | 5.1  | 3.2   | 3.6   |
| Forex loss / (gain)                 | 2.5  | 0.5  | 0.7   | 0.7   |
| EBITDA margins                      | 7.4  | 11.5 | 15.0  | 14.2  |
| Net profit margins                  | 1.1  | 6.6  | 8.5   | 7.5   |

## Growth metrics (%)

| Year To March | FY05   | FY06  | FY07E | FY08E  |
|---------------|--------|-------|-------|--------|
| Revenues      | (3.0)  | 26.3  | 106.1 | (6.8)  |
| EBITDA        | (51.1) | 97.4  | 169.1 | (12.1) |
| Net profit    | (91.5) | 672.5 | 164.0 | (17.4) |
| EPS           | (91.5) | 672.5 | 164.0 | (17.4) |

## Cash flow statement

| Cash flow statement                 |              |                 |              | (INR mn)     |
|-------------------------------------|--------------|-----------------|--------------|--------------|
| Year To March                       | FY05         | FY06            | FY07E        | FY08E        |
| Cash flow from operations           | 2,178        | 3,583           | 6,430        | 5,111        |
| Cash for working capital            | 113          | (2,785)         | (5,544)      | 782          |
| <b>Net operating cash flow</b>      | <b>2,292</b> | <b>798</b>      | <b>886</b>   | <b>5,892</b> |
| Net purchase of fixed assets        | (1,704)      | (1,200)         | (500)        | (500)        |
| Net purchase of investments         | 2,337        | (28,450)        | -            | -            |
| <b>Net cash flow from investing</b> | <b>633</b>   | <b>(29,650)</b> | <b>(500)</b> | <b>(500)</b> |
| Proceeds from equity capital        | (432)        | (436)           | (436)        | (861)        |
| Proceeds from LTB/STB               | 2,363        | 21,572          | -            | -            |
| <b>Net cash flow from financing</b> | <b>1,931</b> | <b>21,136</b>   | <b>(436)</b> | <b>(861)</b> |
| <b>Free cash flow</b>               | <b>587</b>   | <b>(402)</b>    | <b>386</b>   | <b>5,392</b> |

| <b>Balance sheet</b>                            |               |               |               | (INR mn)      |
|---|---------------|---------------|---------------|---------------|
| <b>As on 31st March</b>                         | <b>FY05</b>   | <b>FY06</b>   | <b>FY07E</b>  | <b>FY08E</b>  |
| <b>Shareholders funds</b>                       | <b>20,953</b> | <b>22,147</b> | <b>25,589</b> | <b>28,254</b> |
| Capital   | 10,944        | 10,944        | 10,944        | 10,944        |
| Reserves & surplus                              | 10,009        | 11,203        | 14,645        | 17,310        |
| <b>Borrowings</b>                               | <b>2,821</b>  | <b>24,393</b> | <b>24,393</b> | <b>24,393</b> |
| Secured loans                                   | 2,796         | 24,368        | 24,368        | 24,368        |
| Unsecured loans                                 | 25            | 25            | 25            | 25            |
| Deferred tax liability (net)                    | 315           | 315           | 315           | 315           |
| Other term liabilities                          | 176           | 176           | 176           | 176           |
| <b>Sources of funds</b>                         | <b>24,266</b> | <b>47,031</b> | <b>50,474</b> | <b>53,138</b> |
| Gross block                                     | 11,503        | 12,703        | 13,203        | 13,703        |
| Depreciation                                    | 4,445         | 5,704         | 7,330         | 9,019         |
| <b>Net block</b>                                | <b>7,058</b>  | <b>6,999</b>  | <b>5,873</b>  | <b>4,683</b>  |
| Investments                                     | <b>1,487</b>  | <b>29,938</b> | <b>29,938</b> | <b>29,938</b> |
| Inventories                                     | 3,500         | 6,895         | 17,334        | 14,860        |
| Sundry debtors                                  | 3,598         | 4,802         | 9,899         | 9,223         |
| Cash and bank balances                          | 9,346         | 1,629         | 1,578         | 6,110         |
| Loans and advances                              | 11            | 11            | 11            | 11            |
| Other current assets                            | 1,362         | 1,362         | 1,362         | 1,362         |
| <b>Total current assets</b>                     | <b>17,816</b> | <b>14,699</b> | <b>30,184</b> | <b>31,566</b> |
| Current liabilities                             | 4,786         | 6,599         | 16,591        | 14,223        |
| Provisions                                      |               | 694           | 1,620         | 1,515         |
| <b>Total current liabilities and provisions</b> | <b>4,786</b>  | <b>7,294</b>  | <b>18,211</b> | <b>15,738</b> |
| Net current assets                              | <b>13,030</b> | <b>7,405</b>  | <b>11,973</b> | <b>15,828</b> |
| <b>Others</b>                                   | <b>2,690</b>  | <b>2,690</b>  | <b>2,690</b>  | <b>2,690</b>  |
| <b>Uses of funds</b>                            | <b>24,266</b> | <b>47,031</b> | <b>50,474</b> | <b>53,138</b> |
| Book value per share (BV)                       | 274           | 289           | 334           | 369           |

**Ratios**

| <b>Year To March</b> | <b>FY05</b> | <b>FY06</b> | <b>FY07E</b> | <b>FY08E</b> |
|----------------------|-------------|-------------|--------------|--------------|
| ROE (%)              | 1.0         | 7.4         | 16.8         | 12.6         |
| ROCE (%)             | 2.5         | 4.3         | 10.7         | 8.5          |
| Inventory days       | 152         | 217         | 217          | 217          |
| Debtors days         | 67          | 71          | 71           | 71           |
| Fixed assets T/o (x) | 2.9         | 2.0         | 3.9          | 3.5          |
| Debt/equity          | 0.1         | 1.1         | 1.0          | 0.9          |

**Valuations parameters**

| <b>Year To March</b>         | <b>FY05</b>   | <b>FY06</b>  | <b>FY07E</b> | <b>FY08E</b>  |
|------------------------------|---------------|--------------|--------------|---------------|
| EPS, post exceptional (INR.) | 2.8           | 21.3         | 56.2         | 46.4          |
| <i>YoY growth (%)</i>        | <i>(91.5)</i> | <i>672.5</i> | <i>164.0</i> | <i>(17.4)</i> |
| CEPS (INR)                   | 19.9          | 37.7         | 77.4         | 68.5          |
| PE (x)                       | 486.2         | 62.9         | 23.8         | 28.9          |
| Price/BV(x)                  | 4.9           | 4.6          | 4.0          | 3.6           |
| EV/Sales (x)                 | 4.9           | 5.1          | 2.5          | 2.6           |
| EV/EBITDA (x)                | 67.1          | 44.3         | 16.5         | 18.1          |

## Edelweiss Securities

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Automobiles

Banking & Finance

Cement

Auto Ancillaries, Infrastructure, Mid Caps

Engineering, Infrastructure, Telecom

Information Technology

Metals, Mining

Media

Mid Caps

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### RATING INTERPRETATION

|                    |   |                     |   |
|--------------------|---|---------------------|---|
| <b>Buy</b>         | Expected to appreciate more than 20% over a 12-month period | <b>Reduce</b>       | Expected to depreciate up to 10% over a 12-month period     |
| <b>Accumulate</b>  | Expected to appreciate up to 20% over a 12-month period     | <b>Sell</b>         | Expected to depreciate more than 10% over a 12-month period |
| <b>Trading Buy</b> | Expected to appreciate more than 10% over a 45-day period   | <b>Trading Sell</b> | Expected to depreciate more than 10% over a 45-day period   |

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