

Dr. Reddy's Labs

Relative to sector: **Under Review**

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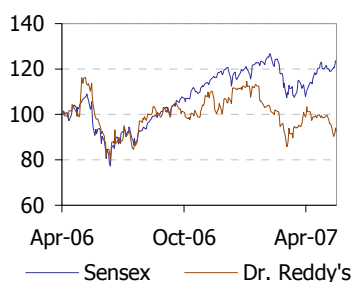
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Relative Performance



Source: Bloomberg, ENAM Research

Stock data

No. of shares	: 167mn
Market cap	: Rs 112bn
52 week high/low	: Rs 840/ Rs.579
Avg. daily vol. (6mth)	: 834,400 shares
Bloomberg code	: DRRD IN
Reuters code	: REDY.BO

Shareholding (%) Mar-07 QoQ chg

Promoters	: 25.2	0.0
FII's	: 27.5	(3.0)
MFs / UTI	: 6.4	0.9
Banks / FIs	: 8.6	1.1
Others	: 32.3	0.9

A BIGGER MOUNTAIN TO CLIMB

Dr. Reddy's Labs' (DRL) Q4FY07 results were better than expected, largely due to strong sales of ondansetron - launched under 180-day exclusivity in end-December 2006 - which resulted in gross margins rising significantly to 62.6% for the period. However higher revenue from ondansetron was offset by a steep drop in revenues from its German generics arm Betapharm. Sales of its authorized generic versions of Zocor and Proscar also tapered down to Rs 1.3bn for the quarter (from peak levels of Rs 7.8bn in Q2) and may decline somewhat further, in coming quarters.

Q4FY07 Highlights

- Total sales for the quarter were up 125% YoY to Rs 15.6bn, while gross profit was up 237% YoY to Rs 9.8bn driven by a surge in gross margins to 62.6%, up 20.8% YoY. While DRL exercised tight control on SG&A (up 50% YoY to Rs 3.4bn) and R&D expenditure (up 26% YoY to Rs 852mn), there was a significant increase in amortization (up 1,271% YoY to Rs 2.2bn) due to a Rs 1.6bn write down on account of impairment charges, on product related intangibles at Betapharm. The management is hopeful that such a charge will not be required in future years; however, this presumes that German generic prices will not be significantly forced down any further.
- While operating income rose smartly to Rs 3.4bn, the shifting of more production to the tax haven of Baddi and tax shields resulting from higher amortization charge, helped raise PAT to Rs 3.3bn for the quarter (against a loss of Rs 237mn in Q4FY06).

We are raising our estimates for FY08 and FY09 by 35% and 6% respectively. At CMP (Rs 666) the stock trades at 14.9x FY08E EPS of Rs 44.8 and at 16.6x FY09E EPS of Rs 40.2. We will assign a rating post our meeting with the management.

Financial summary

Y/E Mar	Sales (Rs mn)	PAT (Rs mn)	Consensus EPS* (Rs.)	EPS# (Rs)	Change YoY (%)	P/E (x)	RoE (%)	RoCE (%)	EV/EBIDTA (x)	DPS (Rs.)
2006	24,267	1,629	-	9.7	671	145.9	7.5	5.4	84.3	2.3
2007	65,095	9,265	-	55.4	469	13.1	34.9	18.8	8.8	3.2
2008E	56,966	7,497	37.1	44.8	(19)	14.9	21.9	15.5	10.7	3.7
2009E	57,738	6,721	43.8	40.2	(10)	16.6	17.6	13.6	11.8	3.7

Source: *Consensus broker estimates, Company, ENAM estimates, # On Fully diluted equity of 167.4mn share

Results update

(Rs mn)	Quarter ended					12 months ended		
	Mar-07	Mar-06	% Chg	Dec-06	% Chg	Mar-08E	Mar-07	% Chg
Total Revenues	15,573	6,932	124.6	15,417	1.0	56,966	65,095	(12.5)
Gross Profit	9,755	2,895	236.9	6,727	45.0	28,891	30,875	(6.4)
S G & A	3,433	2,292	49.8	3,604	(4.8)	15,381	14,051	9.5
R&D Expenses	852	678	25.7	676	26.0	3,626	2,463	47.2
Amortization Expenses	2,221	162	1,271.0	330	573.0	1,400	3,341	(58.1)
Other Operating (Inc.)/Expense	25	4	525.0	(21)	-	-	(4)	-
Forex Loss / (Gain)	(205)	19	-	49	-	-	(137)	-
Operating Income / (Loss)	3,429	(260)	-	2,089	64.2	8,484	11,161	(24.0)
Equity in Loss of Affiliates	(29)	(49)	(40.8)	(12)	141.7	(40)	(63)	(36.5)
Other (Expenses)/ Income (net)	113	12	-	(241)	-	481	(661)	-
PBT and Minority Interests	3,513	(297)	-	1,836	91.4	8,925	10,437	(14.5)
Income tax benefit / (expense)	(260)	61	-	27	-	(1,428)	(1,177)	21.3
Minority Interest	(1)	(1)	-	-	-	-	4	-
Adjusted PAT	3,252	(237)	-	1,863	74.6	7,497	9,265	(19.1)
Extra ordinary income/ (exp.)	-	-	-	-	-	-	63	-
Reported PAT	3,252	(237)	-	1,863	74.6	7,497	9,328	(19.6)
No. of shares (mn)	167.4	167.4	-	167.4	-	167.4	167.4	-
Gross margins (%)	62.6	41.8	-	43.6	-	50.7	47.4	-
PBDIT margins (%)	38.8	2.4	-	15.9	-	20.0	22.7	-
EPS - annualized (Rs.)	77.7	(5.7)	-	44.5	74.6	44.8	55.4	-

Source: Company, ENAM Research

Sales mix*

(Rs mn)	Mar-07	Mar-06	% Chg	Dec-06	% Chg
Formulations	2,743	2,080	31.9	3,183	(13.8)
- Domestic	1,479	1,269	16.5	1,577	(6.2)
- Exports	1,264	811	55.8	1,606	(21.3)
APIs/Intermediates	3,891	2,091	86.1	2,729	42.6
- Domestic	466	547	(14.9)	482	(3.4)
- Exports	3,426	1,544	121.9	2,247	52.5
Generics	6,693	1,574	325.2	7,665	(12.7)
Others	2,246	1,187	89.2	1,840	22.1
Total	15,573	6,932	124.6	15,417	1.0

Source: Company; Note: * Figures denote US GAAP consolidated sales

Other highlights

- US generics' revenues were boosted by ondansetron (Rs 2.7bn in Q4), which offset revenue lost on its authorized generic versions of simvastatin and finasteride (down to Rs 1.3bn in Q4, from Rs 3.4bn in Q3 and Rs 7.8bn in Q2). We expect ondansetron revenues to be reasonably strong during Q1FY08 as well; however, the loss of the Aciphex patent challenge at the District Court level implies that there is likely to be no significant upside from a Para IV/ authorized generics launch in the current fiscal. The company filed 33 ANDAs during the year, taking total ANDAs pending review to 69.

- Generic revenues in Europe quadrupled during the fiscal to Rs 9.6bn, largely due to the Betapharm acquisition that brought in Rs 8bn of revenues. However, the steep price cuts implemented by the German government have pared margins significantly, as evidenced by the impairment charge. At Rs 800mn, Betapharm sales for Q4 were also obviously impacted by the supply bottleneck resulting from its dispute with Hexal, although management states that this has been resolved.
- Domestic formulation sales rose 17% YoY to Rs 1.5bn for the quarter, driven by some interesting new launches such as Leon (levofloxacin). Its flagship brands such as the analgesic Nise (nimesulide) and anti-ulcerants Omez (omeprazole) and Razo (rabeprazole) also reported excellent growth. Branded formulation exports were also strong through FY07, particularly in key markets such as Russia / CIS (up 35% YoY to Rs 4.6bn) and Central & Eastern Europe (up 46% YoY to Rs 377mn).
- API exports were up sharply, rising 122% YoY to Rs 3.4bn during the quarter. Following strong sales of sertraline API to Teva (which had 180-day exclusivity for the product) earlier during the year, DRL also shipped some quantity of rabeprazole (i.e. prior to the adverse judgement in the Aciphex case). During the fiscal, sales of sertraline and sumatriptan boosted API sales in RoW markets to Rs 5.6bn (up 93% YoY) and to Europe (up 47% YoY to Rs 2.1bn). It filed 23 DMFs during FY07, taking total US DMFs to 104. However, domestic API sales were down 10% YoY to Rs 2.1bn for the fiscal, due to lower prices for quinolones.
- The custom pharmaceutical business reported good growth for the quarter, with sales at Rs 2.2bn (up 89% YoY) although they were flat at Rs 7.8bn for the full year. The business is largely driven by the Roche API facility in Mexico (acquired for USD 57mn in Q3FY06), which accounted for Rs 5.4bn of sales during the fiscal.
- R&D expenses were up 26% YoY at Rs 678mn during the quarter and constituted 5% of sales. The management hopes to receive permission to conduct pivotal studies on its diabetes drug balaglitazone during the current fiscal. It has also field for orphan drug status for its oncological drug DRF-1042.

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