Update

SECTOR: PHARMACEUTICALS

Dr. Reddy's Laboratories

STOCK INFO.	BLOOMBERG
BSE Sensex: 11,192	DRRD IN
	REUTERS CODE
S&P CNX: 3,274	REDY.BO

Equity Shares (m)	76.5
52-Week Range (Rs)	1,754/755
1,6,12 Rel. Perf. (%)	3/9/27
M.Cap. (Rs b)	110.3
M.Cap. (US$ b)	2.4

11 August 2006

Buy

Previous Recommendation: Buy

Rs1,441

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
03/06A	24,267	1,371	17.9	579.6	80.6	5.0	6.2	2.5	5.6	85.2
03/07E	39,787	3,316	43.2	141.9	33.3	4.5	13.4	6.2	3.3	21.4
03/08E	46,513	5,043	65.8	52.1	21.9	3.9	17.7	8.8	2.8	16.7
03/08E**	48,059	5,190	67.7	56.5	21.3					

*** Includes sustainable upsides, but excludes one-time upsides*

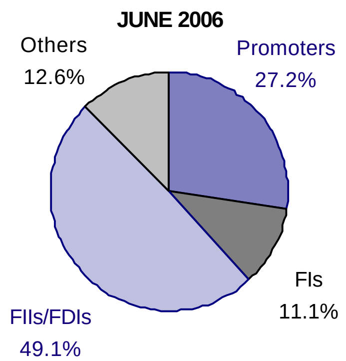
Cautious optimism visible: Management has outlined optimism about future prospects, based on its strong regulated market generic pipeline, acquisitions and its NCE pipeline. However, the management expects further intensification of competition in generics business.

Growth drivers: Growth in the near-to-medium term will be driven by the global generics model, as DRL acquires critical mass in its generic businesses in the US and EU through organic and inorganic routes. Maximization of the opportunities in its established businesses of APIs and branded formulations will also be key contributors to future growth.

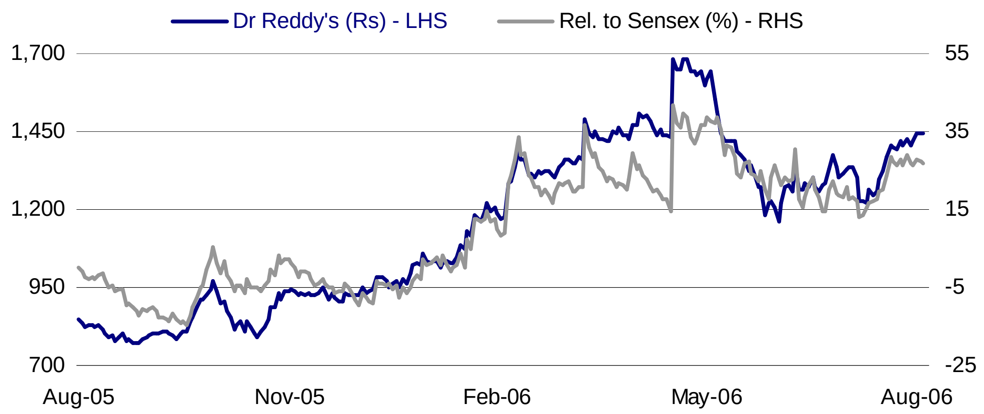
German market – changes in pricing scenario: The German government passed the Economic Optimization of the Pharmaceutical Care Act which became effective 1 May 2006, which tries to contain the healthcare expenses. The impact of changes in pricing scenario on the competitive landscape will unfold only in FY07. Although price reductions will impact margins, given the lower genericisation in German market, any negative impact of lowering of prices would be partially off-set by higher volume growth.

Recommend Buy: Improvement in core business, especially in the US coupled with large one-time opportunities will result in increased traction. The German operations are likely to contribute positively to margins despite the recent price cuts. DRL is currently valued at 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 Rs29.5/share to DRL's FY07E EPS. Maintain **Buy**.

SHAREHOLDING PATTERN (%)



STOCK PERFORMANCE (1 YEAR)



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Takeaways from Chairman's/CEO Letter/Speech

The Chairman's letter/speech to shareholders symbolized cautious optimism, based on its strong regulated market generic pipeline, promising NCE pipeline and also driven by acquisitions. The Chairman expects to maintain growth momentum in the established businesses of APIs and formulations. Key statements made by Chairman/CEO:

- As of 31 March 2006 our U.S. generic pipeline comprised 49 ANDAs pending with the USFDA, including 29 Para IVs. As far as APIs are concerned, the total number of DMFs now stands at 151 — 81 filed in the US, 28 in Canada and 42 in Europe.
- The two-year carcinogenicity studies on Balaglitazone have been completed and the preliminary findings appear promising and hopefully we will take it to phase-3 clinical development towards end of this fiscal.
- Though the (R&D) pipeline looks modest with three molecules in phase-1 and two molecules in phase-2 clinical development, there are several compounds getting ready to move into development. The potential of a breakthrough drug coming out of this pipeline is far greater if you understand the science behind these molecules.
- Given the way in which your Company's management is charged up and its successes in integrating these international entities, something tells me that you may well be seeing more global acquisitions in the coming years.
- We see further intensification of competition from both, existing global players as well as India and China with significant erosion in pricing to garner higher market share in generics business.

Key observations:

Diversified revenue base: DRL has been able to de-risk its market mix, with largest market (India) contributing around 34% for FY06. With betapharm and the Mexican acquisition, almost 80% of the company's consolidated revenues in FY07 would come from international operations.

DE-RISKED MARKET MIX (RS M)

	2003	2004	2005	2006
India	6,489	7,143	6,693	8,272
Contribution (%)	*35.9*	*35.6*	*34.3*	*34.1*
North America	5,853	5,319	4,349	3,984
Contribution (%)	*32.4*	*26.5*	*22.3*	*16.4*
Europe	1,401	2,789	2,868	4,326
Contribution (%)	*7.8*	*13.9*	*14.7*	*17.8*
Russia	1,676	1,821	2,169	2,676
Contribution (%)	*9.3*	*9.1*	*11.1*	*11.0*
RoW	2,651	3,009	3,439	5,008
Contribution (%)	*14.7*	*15.0*	*17.6*	*20.6*
Total	**18,070**	**20,081**	**19,518**	**24,266**

Source: Company

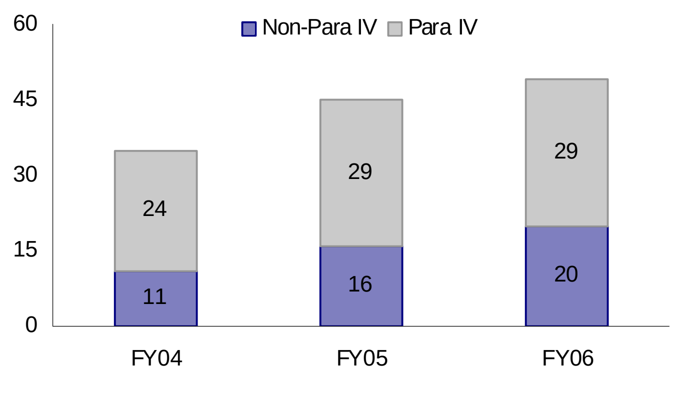
Growth drivers: Growth in the near-to-medium term will be driven by the global generics model, as DRL acquires critical mass in its generic businesses in the US and EU through organic and inorganic routes. Maximization of the opportunities in its established businesses of APIs and branded formulations will also be key contributors to future growth. At the same time, it will continue with its calibrated investments and strategic collaborations in making the innovation-based business self-sustaining – one that creates powerful patent protected product franchises for the long term. This strategy has six key components:

- Pushing revenue growth and profit margins
- Growing the API, branded formulations, generics and custom pharmaceuticals services (CPS) businesses
- Growing research by de-risking R&D
- Capacity expansion – capex of US$100m over next 18 months
- Greater systemic focus on internal controls and supply chain
- Acquisitions

Branded formulation business: DRL is investing in the key markets of India and Russia. To sustain the growth momentum, it has expanded its sales force in India and Russia to drive market shares and maintain a steady flow of new product launches. New products now contribute about 5-6% of total branded formulations revenues, which it aspires to ramp up around 20% in the next few years. Also, DRL's new marketing initiatives in Russia, in form of getting listed in federal program and special campaigns for key products, would aid future growth. DRL also intends to build a sizeable presence in other key markets of South Africa, Brazil and China.

US Generics business: In US generics market, DRL's key priority is to build critical mass that can create a sustainable growth engine for the long term. The company feels that its strong generics pipeline would start contributing to growth FY07 onwards. DRL's generics pipeline is a judicious mix between relatively simple and complex products. Although DRL still has significant number of Para-IV filings, over the last few years, DRL's dependence on Para-IV product has come down due to its initiatives to broad base its product basket. During FY06, DRL filed 12 ANDAs, taking total ANDA filings to 70 and ANDA pending approvals to 49, of which 29 are Para-IVs.

TREND IN PENDING ANDAS



Source: Company

In the US, it is also actively pursuing several business development initiatives to create additional growth opportunities: in-market product acquisitions (during the year acquired 3 off-patent brands from Protein Design Lab), development alliances (entered into development alliances for expanding its pipeline in oral solids as well as alternate dosage forms) to complement DRL's in-house pipeline expansion and authorized generics deals (entered into a AG deal with Merck for generic Zocor and Proscar).

European generic business: Europe is now the single largest market for DRL and it has put in place a new leadership team to design and implement a pan-European strategy focused on building a significant presence in key markets. DRL intends to further build on betapharm's business in Germany, drive scale in UK and expand presence in other important markets of Europe. It is also exploring various business development opportunities in Spain, Italy and France.

German market – changes in pricing scenario: The German government passed the Economic Optimization of the Pharmaceutical Care Act (Arzneimittelversorgungs-Wirtschaftlichkeisgestz, AVWG) which became effective 1 May 2006, which tries to contain the healthcare expenses. Measures taken are, amongst others, forbiddance of free goods to pharmacists, forbiddance of price increases for generics for 2 years, implementation of additional mandatory rebates of 10% if pharmaceutical prices are not 30% below the fixed prices, reduction of fixed prices as of 1 July 2006, possibility to waive co-payments of patients by the SHI organizations. The impact of these changes on the competitive landscape will unfold only in FY07. While price reductions will impact margins, given the lower genericisation in German market, any negative impact of lowering of prices would be partially off-set by higher volume growth.

Growing research by de-risking R&D: DRL's R&D strategy is to continue expanding its discovery pipeline and develop its NCE pipeline through a combination of in-house and co-development initiatives. FY06 saw two deals in discovery:

a) **Formation of Perlecan Pharma:** In March 2006, DRL, ICICI Venture capital and Citigroup Venture Capital entered into a deal to form an integrated drug development company called Perlecan Pharma with equity capital commitment of US$52.5m. As per the agreement, DRL has transferred all rights and titles of four NCEs to Perlecan Pharma. Perlecan would accelerate the development of these assets up to Phase IIa and thereafter seek out licensing, co-development or joint commercialization opportunities.
b) **Development of Balaglitazone:** DRL and Rheoscience have agreed to co-partner the development of Balaglitazone. As per the arrangement, DRL would keep its full rights for North America, Japan and RoW,

except EU (excl Russia and CIS) and China. Balaglitazone is DRLs most advanced NCE in clinical development. The two-year carcinogenicity studies have been completed and the preliminary finds appear promising and should support its further development (Phase III trials).

DRL has been successful in de-risking its R&D by partnering (with I-VEN for US generics and Perlecan for NCE R&D) and co-development (with Rheoscience for Balaglitazone).

Acquisitions: During FY06, DRL acquired two companies to strengthen its CPS business and EU generic business.

- **Acquisition of Roche's API business:** In November 2005, DRL acquired Roche's API business, its order books and its USFDA approved manufacturing plant in Mexico for US$61m. The acquisition also covers current portfolio comprising 18 products including mature APIs as well as range of intermediates and steroids. This acquisition would facilitate DRL's CPS business to grow from US$12m to US$100m in FY07E.
- **Acquisition of betapharm, Germany:** In March 2006, DRL acquired betapharm, Germany's fourth largest generic's company, for EUR483m. The company currently has a portfolio of 145 marketed products having revenues of EUR164m. betapharm acquisition gives DRL a strong foothold in the German generics market.

Financial performance and analysis

During FY06, net sales grew by 24.3% (organic growth of 16.6%) to Rs24.3b, whereas margins expanded by 380bp to 6.6% resulting into recurring PAT (adj for sale of Goa plant) of Rs1.4b (v/s Rs201m).

P&L COMMON SIZE STATEMENT (% OF SALES)

	FY03	FY04	FY05	FY06
Net Sales	100	100	100	100
COGS	43.4	46.4	48.1	51.2
Gross Profit	56.6	53.6	51.9	48.8
SG&A	28.2	33.0	34.7	33.4
R&D	7.8	9.9	14.4	8.9
EBITDA	20.5	10.7	2.8	6.6

Source: Company/ Motilal Oswal Securities

- Gross profit margin declined by 310bp to 48.8% as a result of 27% decline in sales from US generic market.

TREND IN GROSS PROFIT MARGINS (%)

	FY03	FY04	FY05	FY06
API	37.9	33.1	27.8	28.2
Formulations	64.1	65.7	68.1	68.9
Generics	75.2	69.5	54.7	46.5
Critical Care & Biotech	45.3	49.6	66.5	65.9
Overall GP Margins	**56.6**	**53.6**	**51.9**	**48.8**

Source: Company/ Motilal Oswal Securities

- **SG&A expenses** declined by 130bp (to 33.4% of sales) primarily led by 11% decline in legal and professional expenses, despite 18% higher staff cost and 36% higher marketing expenses.
- **R&D Expenses** declined by 550bp (to 8.9% of sales) largely due to lower expenses on clinical trials and income of Rs384m (v/s Rs96m in FY05) under its generic R&D partnership with ICICI Venture.
- **EBITDA margins** expanded by 380bp to 6.6%, witnessing a significant improvement over FY05 led by re-engineering of variable cost and better absorption of fixed cost. Given the expected traction in US generics business and positive contribution from betapharm (despite recent price cuts), margins are expected to improve significantly in FY07.
- **Amortization expenses** were higher by 20% (at Rs420m), primarily on account of amortization of intangibles acquired in the acquisition of Falcon, Trigenesis and betapharm. Further, amortization expenses are expected to be significantly higher at around Rs1.6b for FY07 (as guided by the company during 1QFY07 conference call) as the company amortizes the intangible assets (Rs17b as of FY06) over next few years.

KEY BALANCE SHEET ITEMS (RS M)

	FY03	FY04	FY05	FY06
Net Worth	18,832	21,039	20,953	22,272
Loans	168	628	2,827	30,995
Gearing (x)	0.0	0.0	0.1	1.4
Net Fixed Assets	4,874	6,421	7,160	9,311
Goodwill/Intangible Assets	2,868	2,666	2,588	33,669
Inventory	2,781	3,032	3,500	6,895
Inventory (Days)	56	55	65	104
Debtor	3,643	3,774	3,609	5,054
Debtor (Days)	74	69	68	76

Source: Company/ Motilal Oswal Securities

Balance sheet analysis

- DRL's balance sheet for FY06 witnessed significant increase in loans, inventory and goodwill/intangible assets as a result of two acquisitions (betapharm & Mexico acquisition).
- Increase in loan is in line with the acquisitions done by DRL for which they have paid around US$630-640m (EUR483m for betapharm and US$61m for Mexico facility).
- The increase in net fixed assets primarily reflects assets acquired in Mexico and DRL's new formulation facility at Baddi. The increase in fixed assets was partially offset by the sale of formulation facility at Goa.
- The increase in inventory is partly due to acquisitions and partly due to build-up for planned new product launches in US and expected ramp-up in production activity.

Cash flow analysis: During FY06, there was net cash outflow of Rs5.6b (v/s net inflow of Rs4.9b in FY05). Cash flow from operations stood at Rs1.64b v/s Rs2.29b. Decline in cash flow from operations is primarily due investment of Rs1.87b in working capital (as a result of two acquisitions). As a result of acquisition, there was cash outflow from investment activities to the tune of Rs34.5b (v/s inflow of Rs632.9m) and cash flow from financing activities were at Rs27.2b (v/s Rs1.9b) as DRL took loans to finance acquisitions.

Valuation and view

Improvement in core business (especially) in the US coupled with large one-time opportunities like Fexofenadine, Simvastatin and Finasteride (both authorized generic) and Ondansetron (likely 180-day exclusivity) will result in increased traction. The German operations are likely to contribute positively to margins despite the recent price cuts. DRL is currently valued at 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 Rs29.5/share to DRL's FY07E EPS. Maintain **Buy**.

INCOME STATEMENT (Rs Million)

Y/E MARCH	2004	2005	2006	2007E	2008E
Net Sales	**20,104**	**19,519**	**24,267**	**39,787**	**46,513**
Change (%)	*11.3*	*-2.9*	*24.3*	*64.0*	*16.9*
Total Expenditure	17,955	18,970	22,667	33,624	38,767
EBITDA	**2,149**	**550**	**1,600**	**6,164**	**7,746**
Change (%)	*-42.0*	*-74.4*	*191.1*	*285.2*	*25.7*
Margin (%)	*10.7*	*2.8*	*6.6*	*15.5*	*16.7*
Amortization	383	350	420	1,656	1,350
EBIT	**1,766**	**200**	**1,180**	**4,508**	**6,396**
Other Income - Rec. (incl Fo	774	-93	319	-674	-600
PBT & EO Expense	**2,540**	**107**	**1,499**	**3,834**	**5,796**
Change (%)	*-33.3*	*-95.8*	*1,300.8*	*155.7*	*51.2*
Extra Ordinary Expense	0	0	-388	-63	0
PBT after EO Expense	**2,540**	**107**	**1,887**	**3,897**	**5,796**
Tax	69	-94	258	526	754
Tax Rate (%)	*2.7*	*-88.1*	*13.7*	*13.5*	*13.0*
Minority Interest	-3	-10	0	0	0
Reported PAT	**2,474**	**211**	**1,629**	**3,371**	**5,043**
Adjusted Net Profit	**2,470**	**201**	**1,371**	**3,316**	**5,043**
Change (%)	*-27.6*	*-91.9*	*581.1*	*141.9*	*52.1*
Margin (%)	*12.3*	*1.0*	*5.7*	*8.3*	*10.8*

BALANCE SHEET (Rs Million)

Y/E MARCH	2004	2005	2006	2007E	2008E
Equity Share Capital	383	383	383	383	383
Reserves	20,657	20,571	21,888	24,341	28,138
Net Worth	**21,039**	**20,953**	**22,272**	**24,724**	**28,522**
Loans	628	2,827	30,995	30,995	30,995
Deferred Liabilities/Tax	708	373	6,229	6,229	6,229
Capital Employed	**22,375**	**24,154**	**59,496**	**61,948**	**65,746**
Net Fixed Assets	**6,421**	**7,160**	**9,311**	**12,991**	**13,911**
Investments	4,379	1,487	1,238	1,238	1,238
Goodwill/Intangible Assets	2,666	2,588	33,669	33,669	33,669
Curr. Assets	**13,002**	**17,816**	**24,377**	**24,992**	**29,719**
Inventory	3,032	3,500	6,895	5,968	6,977
Account Receivables	3,774	3,609	5,054	7,361	8,605
Cash and Bank Balance	4,376	9,288	3,713	8,381	10,300
Others	1,820	1,419	8,715	3,282	3,837
Curr. Liability & Prov.	**4,092**	**4,898**	**9,098**	**10,942**	**12,791**
Account Payables	2,375	1,555	3,791	9,947	11,628
Other Current Liabilities	1,717	3,343	5,307	995	1,163
Net Current Assets	**8,909**	**12,918**	**15,278**	**14,051**	**16,928**
Appl. of Funds	**22,375**	**24,154**	**59,496**	**61,948**	**65,746**

*E: MOSt Estimates * As per US GAAP*

RATIOS

Y/E MARCH	2004	2005	2006	2007E	2008E
Basic (Rs)					
EPS	**32.3**	**2.6**	**17.9**	**43.2**	**65.8**
Cash EPS	37.3	7.2	23.4	64.8	83.4
BV/Share	275.0	273.8	290.4	322.4	371.9
DPS	5.0	5.0	5.0	5.6	8.1
Payout (%)	17.1	216.7	31.9	29.7	28.2
Valuation (x)					
P/E		547.9	80.6	33.3	21.9
PEG (x)		-6.0	0.1	0.2	0.4
Cash P/E		200.1	61.7	22.2	17.3
P/BV		5.3	5.0	4.5	3.9
EV/Sales		5.2	5.6	3.3	2.8
EV/EBITDA		186.2	85.2	21.4	16.7
Dividend Yield (%)		0.3	0.3	0.4	0.6
Return Ratios (%)					
RoE	11.7	1.0	6.2	13.4	17.7
RoCE	11.4	0.4	2.5	6.2	8.8
Working Capital Ratios					
Asset Turnover (x)	0.9	0.8	0.4	0.6	0.7
Debtor (Days)	69	67	76	68	68
Inventory (Days)	55	65	104	55	55
Working Capital (Days)	82	68	174	52	52
Leverage Ratio					
Current Ratio (x)	3.2	3.6	2.7	2.3	2.3
Debt/Equity (x)	0.0	0.1	1.4	1.3	1.1

CASH FLOW STATEMENT (Rs Million)

Y/E MARCH	2004	2005	2006	2007E	2008E
Oper. Profit/(Loss) before Ta	2,149	550	1,600	6,164	7,746
Interest/Dividends Recd.	774	-93	319	-674	-600
Direct Taxes Paid	-69	94	-258	-526	-754
(Inc)/Dec in WC	24	902	-7,935	5,896	-958
CF from Operations	**2,877**	**1,454**	**-6,274**	**10,860**	**5,434**
EO Expense	0	0	-388	-63	0
CF from Operating incl	**2,877**	**1,454**	**-5,886**	**10,923**	**5,434**
(inc)/dec in FA	-1,727	-1,012	-33,652	-5,336	-2,270
(Pur)/Sale of Investments	-4,156	2,892	250	0	0
CF from Investments	**-5,884**	**1,880**	**-33,402**	**-5,336**	**-2,270**
Issue of Shares	157	139	127	66	174
(Inc)/Dec in Debt	345	1,865	34,024	0	0
Other Items	3	10	0	0	0
Dividend Paid	-423	-436	-437	-985	-1,420
CF from Fin. Activity	**82**	**1,578**	**33,714**	**-918**	**-1,245**
Inc/Dec of Cash	**-2,924**	**4,912**	**-5,575**	**4,668**	**1,919**
Add: Beginning Balance	7,300	4,376	9,288	3,713	8,381
Closing Balance	**4,376**	**9,288**	**3,713**	**8,381**	**10,300**

Note: Reported cashflow differs due to acquisition

NOTES

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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