



Dr. Reddy's Laboratories

BSE SENSEX 18,684	S&P CNX 5,604	Rs1,552	Buy
Bloomberg Equity Shares (m)	DRRDIN 168.4	YEAR END	NET SALES (RS M)
52-Week Range (Rs)	1,855/1,076	PAT (RS M)	EPS (RS)
1,6,12 Rel. Perf. (%)	-2/12/26	EPS GR. (%)	P/E (X)
M.Cap. (Rs b)	261.4	Adj P/E (X)	P/BV (X)
M.Cap. (US\$ b)	5.7	ROE (%)	ROCE (%)
		EVI SALES	EVI EBITDA
		03/10A	68,179
		03/11E	72,505
		03/11E*	75,630
		03/12E	79,738
		03/12E*	87,187
		03/13E	91,092
			334
			2.0
			64.9
			61.7
			72.9
			95.7
			84.2
			783.4
			23.9
			25.2
			21.3
			16.2
			18.4
			770.0
			23.5
			24.7
			20.9
			15.9
			18.1
			6.1
			5.3
			5.2
			4.5
			2.5
			2.6
			3.8
			3.7
			3.4
			3.0
			23.1
			22.7
			22.0
			18.7

* Includes one-off upsides. Adj P/E for core est is adjusted for DCF value of FTFs & bonus debentures

Dr Reddy's Labs' 3QFY11 operating results were below our estimates. Key highlights are:

- Dr Reddy's Labs 3QFY11 revenues (including one-off upsides) were up 9.8% at Rs18.98b and reported PAT (including one-offs) was Rs2.73b. We estimate one-off/low-competition opportunities to have contributed about Rs1.2b to revenue and Rs348m to PAT. Excluding this, we estimate core sales of Rs17.7b, up 2.4% (against our estimate of Rs19.1b) and core PAT of Rs2.38b was in line with our estimate.
- Revenues were lower than estimates due to lower growth in branded formulations (8.6% growth against our estimate of 18%) with the India formulations business growing by 14.2% against our estimate of 21% and branded formulations exports growing by only 4.4% against our estimate of 15.7%. Revenue growth was adversely impacted by lower growth in core US generic businesses (19.5% growth against our estimate of 42.4%).
- Reported EBITDA (including one-offs) was up 6.4% at Rs3.04b against our estimate of Rs3.43b. Core EBITDA (excluding one-offs, EBITDA was estimated at Rs520m) of Rs2.5b, down 12% YoY against our estimate of Rs2.86b and core EBITDA margins were 14.2% (down 230bp) against our estimate of 15%.
- Reported PAT (including one-offs) of Rs2.73b and core PAT of Rs2.38b were in line with our estimates, boosted by lower taxes (effective tax rate 5.3% against our estimate of 15%).

Traction in the branded formulations and US businesses and focus on improving profitability will be key growth drivers for DRL over the next two years. Based on lower-than-expected 3QFY11 core performance (excluding one-offs), we have cut our core EPS estimates for FY11 and FY12 by 4% each. We estimate core EPS of Rs64.9 for FY11, Rs72.9 for FY12 and Rs84.2 for FY13, adjusting for interest costs of the proposed bonus debentures. Our core estimates exclude the upsides from patent challenges/low-competition opportunities in the US (current DCF value of Rs47/share for visible opportunities). The stock trades at 23.9x FY11E, 21.3x FY12E and 18.4x FY13E core earnings. Maintain **Buy** with a target price of Rs1,710 (20x FY13E core EPS plus Rs27/share DCF value of bonus debentures).

QUARTERLY PERFORMANCE-IFRS

Y/E MARCH	FY10				FY11				FY10	FY11E
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4QE		
Gross Sales	18,189	18,368	17,296	16,424	16,831	18,704	18,985	17,984	70,277	72,505
<i>YoY Change (%)</i>	<i>21.0</i>	<i>13.7</i>	<i>-6.0</i>	<i>-17.3</i>	<i>-7.5</i>	<i>1.8</i>	<i>9.8</i>	<i>9.5</i>	<i>1.2</i>	<i>3.2</i>
EBITDA	3,767	2,749	2,860	2,145	2,727	3,324	3,043	2,724	11,521	11,818
<i>Margins (%)</i>	<i>20.7</i>	<i>15.0</i>	<i>16.5</i>	<i>13.1</i>	<i>16.2</i>	<i>17.8</i>	<i>16.0</i>	<i>15.1</i>	<i>16.4</i>	<i>16.3</i>
Depreciation & Amortization	507	329	8,977	269	288	317	307	318	10,082	1,230
Other Income	-89	348	123	232	14	186	149	192	614	541
Profit before Tax	3,171	2,768	-5,994	2,108	2,453	3,193	2,885	2,598	2,052	11,128
Tax	726	595	-777	441	357	327	152	555	985	1,391
<i>Rate (%)</i>	<i>22.9</i>	<i>21.5</i>	<i>13.0</i>	<i>20.9</i>	<i>14.6</i>	<i>10.2</i>	<i>5.3</i>	<i>21.4</i>	<i>48.0</i>	<i>12.5</i>
Reported PAT	2,445	2,173	-5,217	1,667	2,096	2,866	2,733	2,043	1,067	9,737
Net Profit	2,445	2,173	-5,217	1,667	2,096	2,866	2,733	2,697	1,067	10,739
One Time & EO (Exp)Mnc	734	0	0	0	563	410	348	654	734	1,974
Adjusted PAT	1,711	2,173	-5,217	1,667	1,533	2,456	2,385	2,043	333	8,764
<i>YoY Change (%)</i>	<i>26.9</i>	<i>79.1</i>	<i>-681.6</i>	<i>-115.1</i>	<i>-10.4</i>	<i>13.0</i>	<i>12.6</i>	<i>22.5</i>	<i>-104.5</i>	<i>2,534.2</i>
<i>Margins (%)</i>	<i>9.4</i>	<i>11.8</i>	<i>-30.2</i>	<i>10.1</i>	<i>9.1</i>	<i>13.1</i>	<i>12.6</i>	<i>11.4</i>	<i>0.5</i>	<i>12.1</i>

Note-Estimates do not include one-off upsides.

Revenues impacted by PSAI, global generics business

Dr Reddy's Labs 3QFY11 revenues (including one-off upsides) were up 9.8% at Rs18.98b and PAT (including one-offs) was Rs2.73b. We estimate one-off/low-competition opportunities to have contributed about Rs1.2b to revenue and Rs348m to PAT. Excluding this, we estimate core sales at Rs17.7b, up 2.4% (against our estimate of Rs19.1b) and core PAT was Rs2.38b, in line with our estimates.

Revenues were lower than estimates due to lower growth in the branded formulations business (8.6% growth against our estimate of 18%). The India formulations business grew by 14.2% against our estimate of 21% and branded formulations exports grew by only 4.4% against our estimate of 15.7%. Revenue growth was adversely impacted by lower growth in core US generic businesses (19.5% growth against our estimate of 42.4%). PSAI business degrew by 4.9% YoY to Rs4.98b.

Sales mix & EBITDA trend (Rs m)

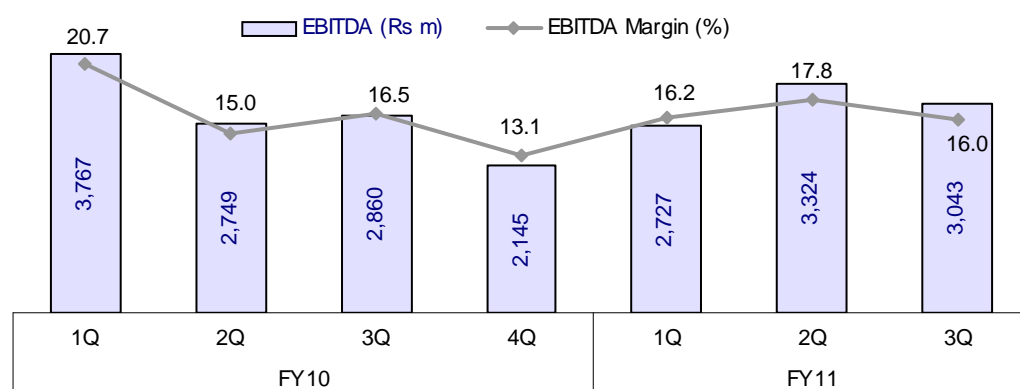
	3QFY11	3QFY10	% Chg	2QFY11	% Chg
PSAI	4,979	5,237	-4.9	4,617	7.8
India	622	607	2.5	653	-4.7
International	4,357	4,630	-5.9	3,964	9.9
Branded Formulations	6,701	6,171	8.6	6,885	-2.7
India	3,007	2,632	14.2	3,160	-4.8
International	3,694	3,539	4.4	3,725	-0.8
Generics	6,888	5,551	24.1	6,782	1.6
North America	4,765	2,972	60.3	4,416	7.9
Europe	2,123	2,579	-17.7	2,366	-10.3
Others	417	336	23.9	420	-0.7
Total Revenues	18,985	17,296	9.8	18,704	1.5

Source: Company/MOSL

Core EBITDA of Rs2.5b was below our estimates

Reported EBITDA (including one-offs) was up 6.4% at Rs3.04b against our estimate of Rs3.43b. Core EBITDA (excluding one-offs EBITDA was estimated at Rs520m) of Rs2.5b was down 12% YoY against our estimate of Rs2.86b and core EBITDA margins were 14.2% (down 230bp) against our estimate of 15%. The management indicated that EBITDA was adversely impacted by non-recurring costs of ~US\$9m pertaining to Allegra D-24 litigation costs in the US, a ramp-up in OTC business costs in Russia and costs related to refinancing of Betapharm loans. We view these expenses as normal business expenses.

EBITDA margin trend



Source: Company/MOSL

Adjusted PAT of Rs2.38b in line with our estimates, guidance reiterated

Reported PAT (including one-offs) of Rs2.73b and core PAT of Rs2.38b were in line with our estimates, boosted by lower taxes (effective tax rate of 5.3% against our estimate of 15%).

The management reiterated its FY11 RoCE guidance of 18-22%, in line with its long-term goal of achieving RoCE of 25% by FY13 and revenue of about US\$3b. It indicated that if some low-competition launches like generic Arixtra and Allegra D-24 went through in 4QFY11, RoCE may be close to the upper end of guidance, otherwise a base case RoCE may be lower than 18% (the lower end of the guidance). Our base-case estimate for FY11 RoCE is 16.4%. FY11 tax rate is expected at 12%.

Status of low competition/patent challenge opportunities in the US

The DRL management has been guiding for the launch of at least one patent challenge/low-competition product in the US every year over the next few years. DRL has a pipeline of 12 FTFs targeting an innovator market size of ~US\$9b. A combination of scale-up in existing patent challenge/low-competition products and new opportunities will help the company to achieve its revenue guidance of US\$1b by FY13 in the US.

DRL US portfolio - one-time PAT contribution (Rs m)

Product	Launch Status	FY10	FY11E	FY12E
Omeprazole OTC	Launched	64	642	1,051
Generic Imitrex	Launched	734	-	-
Generic Arixtra	Awaiting US FDA approval	-	-	1,081
Generic Allegra D-24	Launch possible only post favourable court verdict (expected in Mar-2011)	-	-	-
Generic Lotrel	Launched	-	478	-
Generic Prograf	Launched	-	487	-
Generic Accolate	Launched	-	123	362
Generic Zyprexa	Likely launch on 23-Oct-2011	-	-	2,893
Generic Prevacid	Launched on 15-Oct-2010	-	245	1,051
Total		798	1,974	6,438

Source: Company/MOSL

Settles Nexium litigation with AstraZeneca: potential one-time PAT upside of over US\$50m in FY15

DRL indicated that it entered into an out-of-court settlement with AstraZeneca over the Nexium patent litigation. The settlement allows DRL to launch its generic version of this US\$2.8b product on 27 May 2014 in the US. We are positively surprised by this development since it was widely assumed that Ranbaxy had 180-day exclusivity on this product through its settlement with AstraZeneca with scheduled launch in May 2014. Ideally DRL should be allowed in the market after the expiry of Ranbaxy's 180-day exclusivity. A similar uncertainty had arisen last year when Teva entered into an arrangement with AstraZeneca. Teva later clarified that it would enter the market after Ranbaxy's exclusivity or in May 2014 if Ranbaxy was unable to get final US FDA approval for generic Nexium. While the DRL management declined to clarify, we estimate that it can potentially generate one-time PAT of Rs2.35b in the six months after launch (May-November 2014) if Ranbaxy is unable to enter the market.

DRL - generic nexium upside

Year	May-2014 (FY15)
Status/Option	Normal Generic
Innovator Sales (US\$m)	2,800
Sales period (mths)	6
Price discount (%)	60
Potential Mkt for generics	560
No. of players in mkt	3
DRL Mkt Share (%)	20
DRL Sales (US\$m)	112
Assumed exchange rate (Rs/US\$)	42
DRL Sales (Rs m)	4,704
PAT Margin (%)	50
One-time PAT (Rs m)	2,352
One-time EPS (Rs/sh)	14.0

Source: Company/MOSL

Allegra goes OTC in the US, a negative development

The US FDA has allowed Sanofi to take all forms of Allegra (Fexofenadine HCl) over-the-counter (OTC) in the US. Sanofi, the innovator for Allegra, indicated it would launch OTC versions of Allegra in the US in March 2011. DRL is a key player in the Allegra market and has been selling the normal dosage form of generic Allegra in the US for many years with annual revenue of US\$20m-25m. It also has patent litigations with Sanofi on Allegra D-24 on which the court is expected to pass verdict in a few months. This is a near-term low-competition opportunity for DRL with estimated on-time PAT upside of US\$10m-15m in the exclusivity period. Since the innovator plans to take the drug OTC, DRL will also have to shift these dosages to the OTC segment. While this will not impact the outcome of the patent litigation, we believe the overall upside to DRL may be reduced. Generally, it is difficult for generic companies to gain significant market share in the OTC segment since the consumer is brand conscious.

Plans generic Lipitor launch: may not have large upside

The DRL management indicated that it intended to launch generic Lipitor (Pfizer's US\$7b brand) in the US after the expiry of Ranbaxy's 180-day exclusivity in May 2012. It is in litigation with Pfizer on this product. We do not expect this to be a big opportunity for DRL since it expects to enter the market after Ranbaxy's exclusivity, along with other generic companies. Mylan has an out-of-court settlement with Pfizer for this product but has not disclosed its launch time line. However, the DRL management indicated that it would not undertake an "at-risk" launch of the product pending outcome of its patent litigation.

Branded formulations business to sustain double-digit growth

Despite lower-than-expected growth of the branded formulations business in 3QFY11, we expect DRL to sustain 17-18% revenue CAGR led by:

- an expanding field force in India and new launches and
- an expanding presence in the Russian OTC market along with additional growth drivers like in-licensed products.

Adequately hedged for a year

DRL has forex hedges of ~US\$540m, taken between Rs47-48/US\$ which, we believe, will be adequate for the next four quarters. Its net US dollar exposure for the next one year is expected at ~US\$600m.

Valuation and view

Traction in the branded formulations and US businesses and focus on improving profitability will be key growth drivers over two years. Based on lower-than-expected 3QFY11 core performance (excluding one-offs), we have cut our core EPS estimates for FY11 and FY12 by 4% each. We estimate core EPS of Rs64.9 for FY11, Rs72.9 for FY12 and Rs84.2 for FY13, adjusting for the interest cost of proposed bonus debentures. Our core estimates exclude upsides from patent challenges/low-competition opportunities in the US (current DCF value of Rs47/share for visible opportunities). The stock trades at 23.9x FY11E, 21.3x FY12E and 18.4x FY13E core earnings. Maintain **Buy** with a target price of Rs1,710 (20x FY13E core EPS plus Rs27/share DCF value of bonus debentures).

Dr. Reddy's Laboratories: an investment profile

Company description

Dr Reddy's is a vertically integrated company with presence in the pharmaceutical value chain through its core businesses of global generics, pharmaceutical services and active ingredients (PSAI), and proprietary products. The company is developing bio-generics and NCEs. Key focus markets include India, the US, Europe and Russia.

Key investment arguments

- The company aims to improve profitability over two years, led by strategic prioritization in generic markets, contribution from low-competition opportunities in the US, restructuring of German operations, ramp-up in the biologics business and double-digit growth in emerging markets.
- The company's long-term revenue target is US\$3b by FY13 (implied CAGR of 21% over FY09-13) and RoCE of 25%.
- Revenue and earnings CAGR of 13% and 21% respectively over FY08-12.

Key investment risks

- The US FDA has, of late, become stringent in evaluating cGMP compliance and issued warning letters to many leading Indian players. A slippage could impact Dr Reddy's US supplies.
- Higher-than-expected currency appreciation could adversely impact future earnings.

Recent developments

- Launched generic Accolate and Prevacid, which are low competition opportunities, in the US.
- Favorable results announced in the first phase-III for NCE Balaglitazone.

Valuation and view

- We expect core EPS CAGR of 25% over FY08-13 (FY09/10 EPS has suffered due to Betapharm write-offs).
- The stock trades at 23.9x FY11E, 21.3x FY12E and 18.4x FY13E core earnings adjusted for DCF value of FTFs and the proposed bonus debentures.

Sector view

- Emerging markets and Para-IV upsides remain key sales and profit drivers in the medium term.
- We are Overweight on companies that have a differentiated business model for the US.

Comparative valuations

		DRL	Cipla	Ranbaxy
P/E (x)	FY11E	23.9	27.4	13.8
	FY12E	21.3	21.8	44.1
P/BV (x)	FY11E	5.3	4.2	3.1
	FY12E	5.2	3.7	2.8
EV/Sales (x)	FY11E	3.7	4.5	2.6
	FY12E	3.4	3.9	2.9
EV/EBITDA (x)	FY11E	22.7	19.6	13.4
	FY12E	22.0	16.4	27.2

Shareholding Pattern (%)

	Dec-10	Sep-10	Dec-09
Promoter	25.7	25.7	25.8
Domestic Inst	13.1	15.7	18.5
Foreign	48.3	44.6	42.4
Others	13.0	14.0	13.3

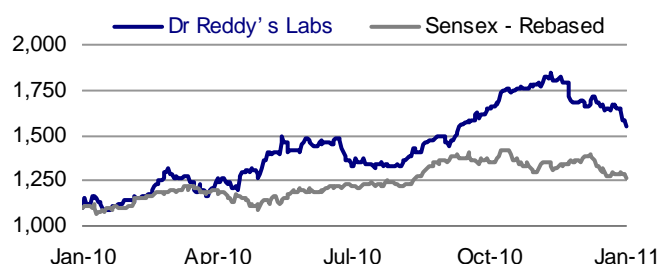
EPS: MOSL forecast v/s consensus (Rs)

	MOSL Forecast	Consensus Forecast	Variation (%)
FY11	64.9	66.8	-2.8
FY12	72.9	86.1	-15.3

Target Price and Recommendation

Current Price (Rs)	Target Price (Rs)	Upside (%)	Reco.
1,552	1,710	10.2	Buy

Stock performance (1 year)



Financials and Valuation

INCOME STATEMENT		(Rs Million)				
Y/E MARCH	2009	2010	2011E	2012E	2013E	
Net Sales	69,441	70,277	72,505	79,738	91,092	
Change (%)	38.9	1.2	3.2	10.0	14.2	
Other Income	-94	617	800	864	968	
Cost of Goods Sold	32,941	33,937	33,860	38,274	43,269	
Total Expenditure	56,495	58,756	60,686	67,379	76,699	
EBITDA	12,946	11,521	11,818	12,359	14,393	
Change (%)	93.2	-11.0	2.6	4.6	16.5	
Margin (%)	18.6	16.4	16.3	15.5	15.8	
Amortization	15,526	10,082	1,230	1,107	996	
EBIT	-2,580	1,439	10,588	11,252	13,396	
Net Interest Exp	688	75	-16	733	579	
Forex (Gains)/Losses	634	-72	275	0	0	
PBT & EO Expense	-3,996	2,053	11,129	11,383	13,785	
Change (%)	-216.2	-151.4	442.1	2.3	21.1	
PBT after EO Expense	-3,996	2,053	11,129	11,383	13,785	
Tax	1,173	985	1,391	1,708	2,343	
Tax Rate (%)	-29.4	48.0	12.5	15.0	17.0	
Reported PAT	-5,169	1,068	9,738	9,676	11,442	
PAT adj for EO Items	-5,169	1,068	9,738	9,676	11,442	
Adjusted Net Profit	-5,169	1,068	10,948	12,307	14,210	
Change (%)	-210.7	-120.7	925.1	12.4	15.5	
Margin (%)	-7.4	1.5	15.1	15.4	15.6	

BALANCE SHEET		(Rs Million)				
Y/E MARCH	2009	2010	2011E	2012E	2013E	
Equity Share Capital *	842	844	844	844	844	
Reserves	41,203	42,071	48,617	49,654	56,953	
Net Worth	42,045	42,915	49,461	50,498	57,797	
Loans	19,701	14,695	13,695	13,747	13,747	
Deferred Liabilities/Tax	3,411	1,438	1,438	1,438	1,438	
Capital Employed	65,157	59,048	64,594	65,683	72,982	
Net Fixed Assets	21,144	22,769	28,769	32,769	35,969	
Investments	730	3,843	3,843	2,343	2,343	
Goodwill/Intangible Assets	22,179	13,973	13,017	13,017	13,017	
Curr. Assets	38,480	38,463	37,817	36,691	42,604	
Inventory	13,226	13,371	15,226	15,150	16,397	
Account Receivables	14,592	11,960	14,501	14,353	15,486	
Cash and Bank Balance	5,596	6,584	2,652	1,208	3,890	
Others	5,066	6,548	5,438	5,980	6,832	
Curr. Liability & Prov.	17,376	20,000	18,851	19,137	20,951	
Account Payables	5,987	9,322	7,975	8,771	10,020	
Other Current Liabilities	11,389	10,678	10,876	10,366	10,931	
Net Current Assets	21,104	18,463	18,966	17,554	21,653	
Appl. of Funds	65,157	59,048	64,595	65,683	72,982	

* IFRS reporting from FY08 onwards. Financials prior to FY08 are as per US GAAP
E: MGS Estimates;

RATIOS						
Y/E MARCH	2009	2010	2011E	2012E	2013E	
Basic (Rs)						
EPS	-30.7	6.3	64.9	72.9	84.2	
Cash EPS	61.5	66.1	72.1	79.5	90.1	
BV/Share	249.7	254.2	293.0	299.2	342.4	
DPS	3.1	0.8	8.1	9.1	10.5	
Payout (%)	0.0	28.2	29.2	29.2	29.2	
Valuation (x)						
P/E	-50.6	245.4	23.9	21.3	18.4	
Cash P/E	25.2	23.5	21.5	19.5	17.2	
P/BV	6.2	6.1	5.3	5.2	4.5	
EV/Sales	4.0	3.8	3.7	3.4	3.0	
EV/EBITDA	21.2	23.1	22.7	22.0	18.7	
Dividend Yield (%)	0.2	0.0	0.5	0.6	0.7	
Return Ratios (%)						
RoE	-12.3	2.5	22.1	24.4	24.6	
RoCE	-2.9	2.6	16.4	18.2	19.1	
Working Capital Ratios						
Fixed Asset Turnover (x)	3.6	3.2	2.8	2.6	2.7	
Debtor (Days)	77	62	73	66	62	
Inventory (Days)	70	69	77	69	66	
Working Capital (Days)	82	62	82	75	71	
Leverage Ratio						
Current Ratio (x)	2.2	1.9	2.0	1.9	2.0	
Debt/Equity (x)	0.5	0.3	0.3	0.3	0.2	

CASH FLOW STATEMENT		(Rs Million)				
Y/E MARCH	2009	2010	2011E	2012E	2013E	
Op. Profit/(Loss) before Tax	12,946	11,521	11,818	12,359	14,393	
Interest/Dividends Recd.	-1,416	614	541	131	389	
Direct Taxes Paid	-1,173	-985	-1,391	-1,708	-2,343	
(Inc)/Dec in WC	-6,817	3,629	-4,435	-33	-1,417	
CF from Operations	3,540	14,779	6,533	10,750	11,021	
EO Expense	0	0	0	0	0	
CF from Operating incl	3,540	14,779	6,533	10,750	11,021	
(inc)/dec in FA	-8,268	-3,501	-6,274	-5,107	-4,196	
(Pur)/Sale of Investments	4,263	-3,113	0	1,500	0	
CF from Investments	-4,005	-6,614	-6,274	-3,607	-4,196	
Change in networth	0	103	0	-5,052	0	
(Inc)/Dec in Debt	159	-5,006	-1,000	52	0	
Other Items	-265	-1,973	0	0	0	
Dividend Paid	-1,232	-301	-3,191	-3,587	-4,142	
CF from Fin. Activity	-1,338	-7,177	-4,191	-8,587	-4,142	
Inc/Dec of Cash	-1,802	988	-3,932	-1,444	2,683	
Add: Beginning Balance	7,398	5,596	6,584	2,652	1,208	
Closing Balance	5,596	6,584	2,652	1,208	3,891	

Note: Reported cashflow differs due to acquisitions & change to IFRS reporting from FY08 onwards



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Disclosure of Interest Statement

Dr. Reddy's Laboratories

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| 1. Analyst ownership of the stock | No |
| 2. Group/Directors ownership of the stock | No |
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