

INDIA

Dr Reddy's Laboratories

21 May 2007

DRRD IN **Outperform**

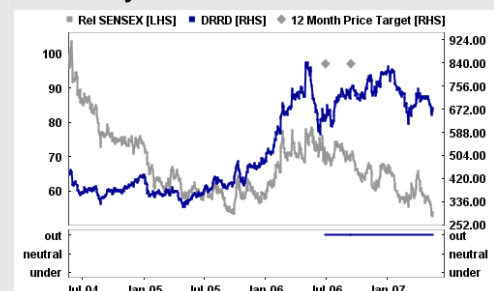
Stock price as of 18 May 07	Rs	665.75
12-month target	Rs	837.50
Upside/downside	%	+25.8
Valuation	Rs	837.50
- Sum of Parts		

GICS sector	pharmaceuticals biotechnology & life sciences
Market cap	Rs m 110,525
30-day avg turnover	US\$m 14.8
Market cap	US\$m 2,722
Number shares on issue	m 166.0

Investment fundamentals

Year end 31 Mar		2006A	2007A	2008E	2009E
Total revenue	m	23,550	65,095	44,870	48,894
EBIT	m	1,518	12,858	6,971	7,784
EBIT Growth	%	nmf	747	-7.8	11.7
Adjusted profit	m	1,147	10,832	5,522	6,682
EPS adj	Rs	7.46	64.41	35.89	43.43
EPS adj growth	%	246.7	763.4	0.7	21.0
PE adj	x	89.3	35.6	18.6	15.3
Total DPS	Rs	2.50	3.75	4.25	4.25
Total div yield	%	0.4	0.6	0.6	0.6
ROA	%	3.3	22.8	11.3	13.5
ROE	%	5.7	26.2	20.2	20.7
EV/EBITDA	x	39.7	8.7	12.4	11.5
Net debt/equity	%	103.3	35.0	44.5	20.1
Price/book	x	4.9	2.9	3.5	2.9

DRRD IN rel SENSEX performance, & rec history



Source: Datastream, Macquarie Research, May 2007 (all figures in INR unless noted)

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Record 4Q – stock looks attractive

Event

- Dr Reddy's Laboratories (DRL) released record 4Q FY3/07 and FY3/07 results; the top and bottom lines were significantly ahead of consensus and our estimates. While 4Q revenue came in 16% higher than the street's expectations, adjusted net profit was more than three times the consensus estimate. Strong performance of 'exclusivity-led' generic products in the US, strong CPS revenues and forex gains led to the strong performance in 4Q.

Impact

- DRL's revenue for the quarter was up 123% YoY at Rs15.6bn.** The successful launch of generic Ondansetron towards end-December 2006 contributed to the strong performance in 4Q with sales of Rs2.7bn. With almost three months of the exclusivity period still remaining (to expire on 21 June), we expect Ondansetron to add significantly to 1Q FY3/08 revenue.
- DRL registered adjusted PAT of Rs4.9bn in 4Q surpassing expectations.** Significant improvement in gross margin across all segments resulted in record PAT. While gross margin improvement in the base business seems sustainable, the gross margin for US generics will be highly dependent upon the launch of 'exclusivity-led' products. Management aims to maintain a gross margin of 50–52% overall in FY3/08E. Although EPS growth is expected to be negative in FY3/08E, all the base businesses should grow strongly. Management reaffirmed its guidance of positive growth in Betapharm revenues in FY3/08 in spite of the health reforms underway in Germany and the supply constraints faced in 4Q.
- For the full year FY3/07, revenue grew 168% to Rs65.1bn** compared to Rs24.3bn in FY3/06. Adjusted net profit for the full year stood at Rs10.8bn compared to Rs1.3bn in the previous year. Multiple Para IV launches in the US generic market by DRL led to the strong performance for the year.
- 13 ANDAs filed during 4Q FY3/07.** This is by far the highest number of ANDAs filed by DRL in one quarter. DRL believes it has FTF rights on 18 products covering a total brand sales market size of US\$10bn.
- We expect DRL to launch at least 10 new products in the US generic market in FY3/08E.** However, we have not yet factored any potential launch of Para IV into our earnings model.

Earnings revision

- No change.

Price catalyst

- 12-month price target: Rs837.50 based on a Sum of Parts methodology.
- Catalyst: 1) Exclusivity sales of two plus months from generic Zofran; and 2) potential out-licensing of Balaglitazone NCE.

Action and recommendation

- The stock looks attractive at a PER of 15.3x FY3/09E. Maintain Outperform.

Please refer to the important disclosures on inside back cover of this document, or on our website www.macquarie.com.au/research/disclosures.

Fig 1 Dr Reddy's Laboratories – 4Q FY3/07 and FY3/07 results

Yr to Mar (Rs m)	Mar-06	Jun-06	Sep-06	Dec-06	Mar-07	QoQ (in %)	YoY (in %)	FY06	FY07	YoY (in %)
Domestic sales	1,815	2,240	2,245	2,059	1,946	(5.5)	7.2	7,822	8,490	8.5
- Branded Formulations	1,269	1,615	1,743	1,577	1,480	(6.2)	16.6	5,526	6,415	16.1
- Bulk Drugs	546	625	502	482	466	(3.3)	(14.7)	2,296	2,075	(9.6)
Export Sales	3,929	10,134	15,830	11,535	11,382	(1.3)	189.7	14,398	48,881	239.5
- Branded Formulations	811	1,721	1,313	1,606	1,264	(21.3)	55.9	4,400	5,904	34.2
- Bulk Drugs	1,544	1,676	2,404	2,247	3,426	52.5	121.9	5,942	9,753	64.1
- Generics	1,574	6,737	12,113	7,682	6,692	(12.9)	325.2	4,056	33,224	719.1
Custom pharmaceuticals	1,037	1,418	1,668	1,569	1,945	24.0	87.6	1,327	6,600	397.4
Diagnostics and others	29	58	69	67	630	840.3	2,072.4	29	824	2,741.4
Emerging business (critical care & biotechnology)	164	198	227	204	-330	(261.8)	(301.2)	691	299	(56.7)
Total revenues	6,974	14,048	20,039	15,434	15,573	0.9	123.3	24,267	65,094	168.2
Cost of revenues	4,036	7,960	11,751	8,690	5,818	(33.0)	44.2	12,417	34,219	175.6
Gross profit	2,938	6,089	8,288	6,744	9,755	44.6	232.0	11,850	30,876	160.6
SG&A expenses	2,279	3,346	3,667	3,604	3,433	(4.7)	50.6	8,029	14,050	75.0
R&D Expenditure	678	533	402	676	852	26.0	25.7	2,153	2,463	14.4
In Process R&D acquisition charge	-	-	-	-	-	-	-	-	-	-
Amortization expenses	162	388	402	330	451	36.7	178.4	420	1,571	274.0
Forex loss/ (gain)	18	74	-54	49	-205	(518.4)	(1,238.9)	126	-136	(207.9)
Other operating income/(expense)	-	-	2	20	-25	(225.0)	-	-	-3	-
Operating income	-199	1,748	3,873	2,105	5,199	147.0	(2,712.6)	1,122	12,925	1,052.0
Equity in loss of affiliates	48	-	21	12	29	141.7	(39.6)	88	62	(29.5)
Other expenses/(income) net	437	142	321	241	-113	(146.9)	(125.9)	-534	591	(210.7)
Extraordinary expenses (income)	-388	-	-	-	1,770	-	-	-320	1,770	(653.1)
Profit before income taxes	-296	1,606	3,531	1,852	3,513	89.7	(1,286.8)	1,888	10,502	456.3
Income tax (benefit)/expense	-62	208	737	-27	260	(1,063.0)	(519.4)	258	1,178	356.6
<i>Effective tax rate</i>	<i>21%</i>	<i>13%</i>	<i>21%</i>	<i>-1%</i>	<i>7%</i>			<i>14%</i>	<i>40%</i>	
Minority interest	-1	-	4	-	-1	-	-	0	3	
Net income	-235	1,398	2,798	1,879	3,252	73.1	(1,483.8)	1,630	9,327	472.2
Adjusted Net Income	-565	1,398	2,798	1,879	4,757	153.1	(942.2)	1,358	10,832	697.6
Margins (%)										
Gross margin (%)	42.1	43.3	41.4	43.7	62.6			48.8	47.4	
Operating margin (%)	-2.9	12.4	19.3	13.6	33.4			4.6	19.9	
Adjusted net profit margin (%)	-8.1	10	14	12.2	30.5			5.6	16.6	
SG&A expenses/Sales (%)	32.7	23.8	18.3	23.4	22			33.1	21.6	
R&D Expenditure/Sales (%)	9.7	3.8	2	4.4	5.5			8.9	3.8	

Source: Company data, Macquarie Research, May 2007

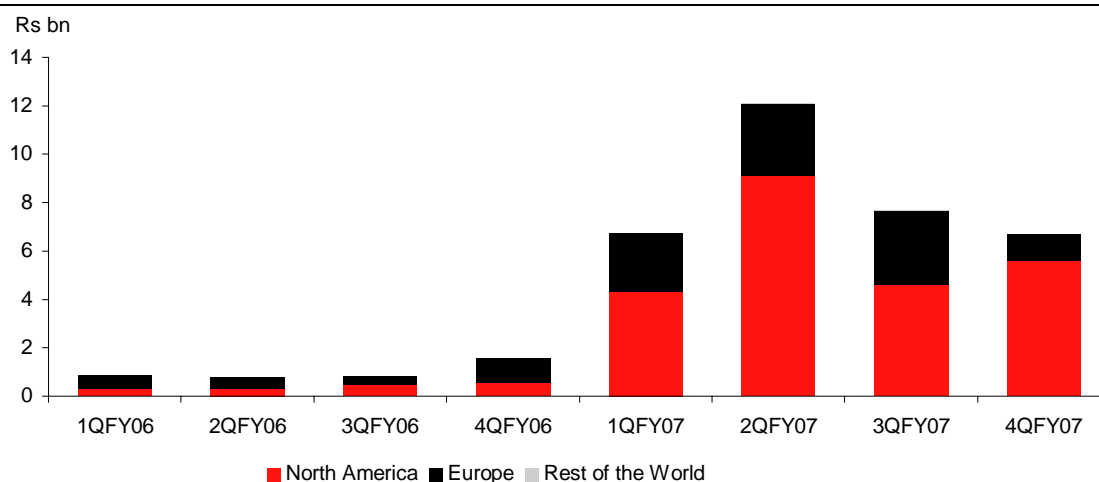
Strong 4Q FY3/07; good outlook for FY3/08E

- **DRL's revenue for the quarter was up 123% YoY at Rs15.6bn.** The successful launch of generic Ondansetron towards the end of December 2006 contributed to the strong performance in 4Q with sales of Rs2.7bn. With almost three months of the exclusivity period still remaining (exclusivity will expire on 21 June), we expect Ondansetron to add significantly to 1Q FY3/08E revenue as well.
- **DRL registered adjusted PAT of Rs4.9bn in 4Q surpassing expectations.** Significant improvement in gross margin across all segment resulted in record PAT in 4Q FY3/07. Gross margin for the quarter was pretty high at 62.6%, largely due to high gross margin in Ondansetron during the exclusivity period. While gross margin improvement in the base business seems sustainable, the gross margin for US generics will be highly dependent upon launch of exclusivity-led products. Management aims to maintain a gross margin of 50–52% overall in FY3/08E. Although EPS growth is expected to be negative in FY3/08E, all the base businesses should grow strongly. Management reaffirmed its guidance of positive growth in Betapharm revenues in FY3/08E in spite of the health reforms underway in Germany and the supply constraints faced in 4Q.
- In terms of divisions, our analysis of revenue growth shows strong growth in all business segments. While the international generic division was the main driver of the growth, other businesses also witnessed solid growth in 4Q FY3/07. Both the branded formulation and API businesses grew more than 30% YoY, leading to strong overall growth for the quarter.

International generics

- In 4Q FY3/07, revenue in the international generic business grew 325% YoY to Rs6.7bn led by the strong performance of Ondansetron. DRL launched the generic version of Ondansetron in the latter part of December 2006. In 4Q FY3/07, Ondansetron generated revenue of Rs2.68bn. Though the company did not provide any information on the gross margin for Ondansetron, we believe the gross margin was in excess of 75%. With almost three months of the exclusivity period still remaining, we expect Ondansetron to add significantly to 1Q FY3/08E revenue and profit as well. We forecast revenue of Rs1.7bn from Ondansetron in 1Q FY3/08E.
- Excluding the contribution from Ondansetron also, revenue grew 155% to Rs4bn. Strong performance of Simvastatin and Fexofenadine post the exclusivity period contributed significantly to the revenue growth. DRL commands a market share of 24% in Simvastatin even after the expiry of the exclusivity period. For Fexofenadine, market share is lower at ~11%, however DRL has maintained pretty high margins resulting in strong growth in profit. The company has seen very little competition in Fexofenadine, even after the expiry of the exclusivity period, as there aren't too many players with final FDA approval. Ranbaxy Laboratories (RBXY IN, Rs397, Not rated) recently received tentative approval for launch of the drug. We believe pricing will be under pressure for DRL after Ranbaxy and other players launch their product. However, until the competition intensifies, we can expect DRL to maintain higher margins on Fexofenadine.

Fig 2 International generics – strong growth from exclusivity-led products



Source: Macquarie Research, May 2007

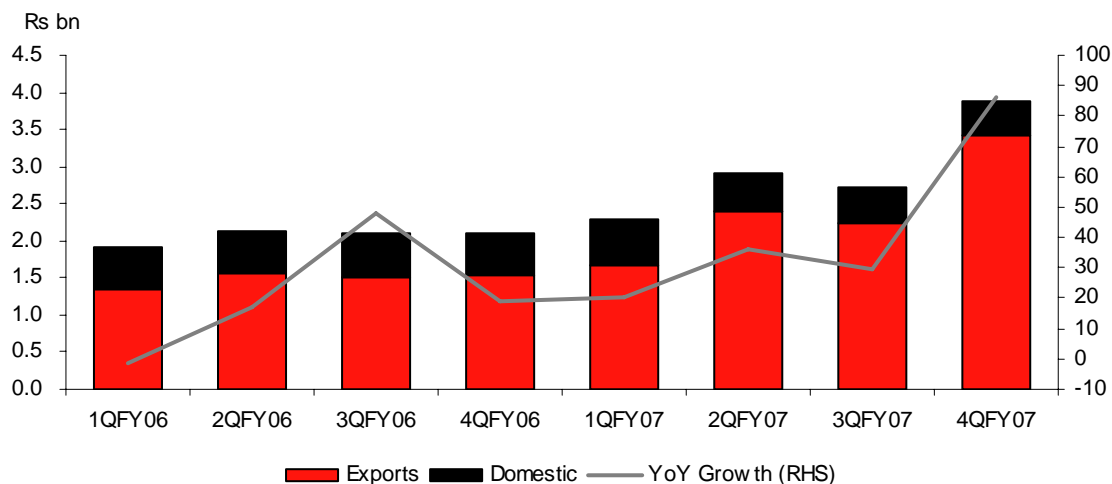
Betapharm – poor performance currently but positive outlook

- Betapharm witnessed a very poor quarter with revenue falling to Rs788m. DRL was trying to sort out a few supply side problems in the last quarter, which had an impact on overall sales. DRL has now renegotiated its contract with Salutas for sourcing of products and made it a non-exclusive one. This will enable DRL to source raw products for Betapharm from India as well. Though the gross margin for Betapharm will fall in the short term, we believe the move is likely to have a positive impact in the long term. As per our estimate, Betapharm's EBITDA margins are pretty low currently but could improve significantly once the delivery of raw products from India starts.
- The healthcare reform in Germany is changing the dynamics of the market quite rapidly. We believe there is a strong possibility of the German market following the US trend of a pure generic market. Prices would fall further, but loss of revenue for most players would be partially offset by increased volumes. We believe DRL is well geared to succeed in the changing environment as well. DRL has done exceedingly well in the pure generic market in the US. With the right systems in place, we believe DRL will be able to succeed even in Germany.

Active pharmaceuticals ingredients

- For 4Q FY3/07, revenue for the active pharmaceuticals ingredient (API) division grew 86% to Rs3.9bn led by strong growth in exports, which rose 122%. Domestic business, however, performed poorly with revenue witnessing a 15% YoY fall. Strong performance by Sertraline and Rabeprazole led to strong overall growth for the division. However, with Teva losing the litigation for Rabeprazole, we expect the growth to slow down in the coming quarter. (Note that DRL was the API supplier to Teva for Rabeprazole). For the full year, revenue grew 43%. In spite of a strong base, management has guided for positive growth for FY3/08E as well. We believe exports will continue to be the main driver of growth in next year as well. The domestic API business is likely to be a drag on the overall growth of the segment.

Fig 3 API business – strong growth in export revenue

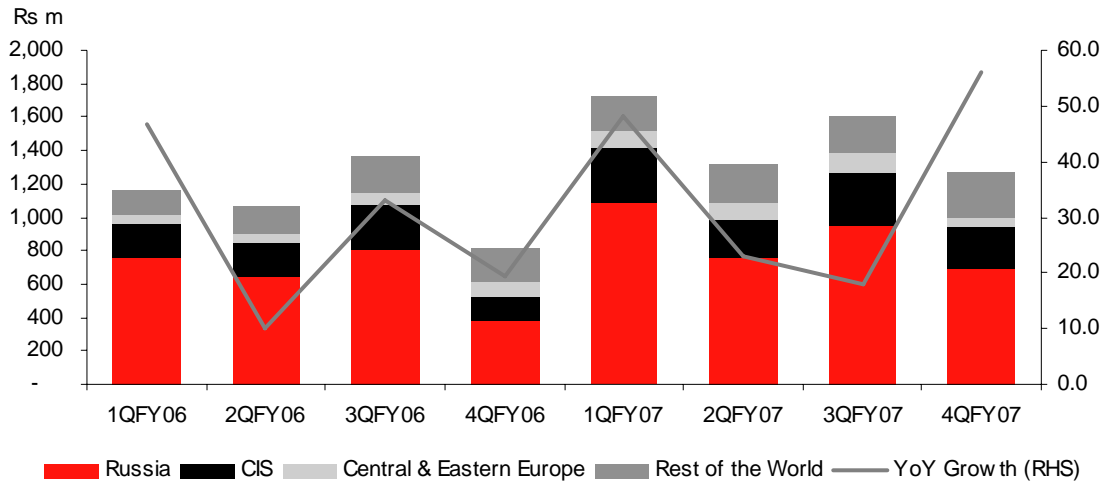


Source: Macquarie Research, May 2007

Branded formulations – international

In 4Q FY3/07, the strong performance in Russia and the CIS markets led to impressive overall growth of DRL's international branded formulation business. Revenue in Russia grew 81% on account of the strong performance of few key brands including Omez, Cetrine, Nise and Keterol. The CIS countries also witnessed solid growth of 71% led by an increase in sales from the Ukraine and Kazakhstan. For the full year FY3/07, revenue grew 34% to Rs5.9bn led by growth in all geographies. Though the company did not provide any guidance on revenue growth, we believe the segment will continue to witness healthy positive growth in FY3/08E as well.

Fig 4 International branded formulations – strong growth

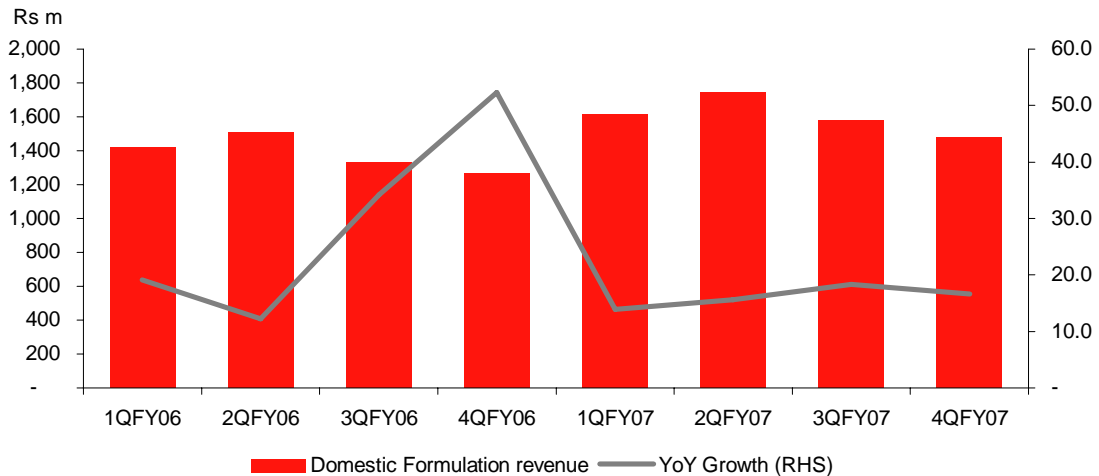


Source: Macquarie Research, May 2007

Domestic formulations – strong growth in key brands

DRL's domestic formulation business saw a healthy growth rate of 17% led by strong performance in key brands of Razo, Nice and Atocor with each witnessing a growth rate of more than 10% in 4Q FY3/07. For the full year, DRL launched 21 new products in the market, which contributed Rs247m in revenue. We believe the domestic formulation business will continue to witness positive growth in FY3/08E led by increased revenue from these launches and strong performance by DRL's key brands.

Fig 5 Domestic formulations

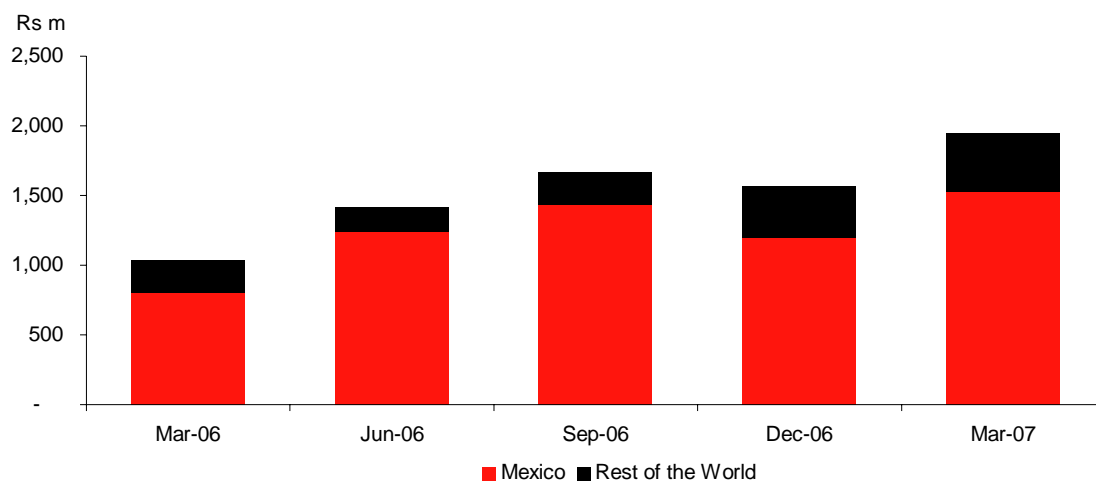


Source: Macquarie Research, May 2007

Custom pharmaceutical business

- DRL's custom pharmaceutical business did exceedingly well in 4Q FY3/07, with revenue growing 88% YoY and 24% QoQ to Rs1.95bn. Mexico contributed Rs1.53bn to the revenue, growing 90% YoY. Excluding Mexico, revenue grew strongly to Rs420m compared to Rs233m in 4Q FY3/06, witnessing growth of 80% YoY. The outlook for the CPS business looks quite promising and we expect strong growth in revenue in F3/08E.

Fig 6 Custom pharmaceutical services – strong growth



Source: Macquarie Research, May 2007

Important disclosures:

Recommendation definitions

Macquarie Australia/New Zealand

Outperform – return >5% in excess of benchmark return (>2.5% in excess for listed property trusts)
 Neutral – return within 5% of benchmark return (within 2.5% for listed property trusts)
 Underperform – return >5% below benchmark return (>2.5% below for listed property trusts)

Macquarie Asia

Outperform – expected return >+10%
 Neutral – expected return from -10% to +10%
 Underperform – expected return <-10%

Macquarie First South Securities (South Africa)

Outperform – expected return >+5%
 Neutral – expected return from -5% to +5%
 Underperform – expected return <-5%

Recommendations – 12 months

Note: Quant recommendations may differ from Fundamental Analyst recommendations

Recommendation proportions

	AU/NZ	Asia	RSA
Outperform	44.37%	58.37%	42.60%
Neutral	44.01%	21.30%	46.80%
Underperform	11.62%	20.33%	10.60%

For quarter ending 31 March 2007

Volatility index definition*

This is calculated from the volatility of historic price movements.

Very high–highest risk – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30–40% in a year.

Low–medium – stock should be expected to move up or down at least 25–30% in a year.

Low – stock should be expected to move up or down at least 15–25% in a year.

* Applicable to Australian/NZ stocks only

Financial definitions

All "Adjusted" data items have had the following adjustments made:
 Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense
 Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

EPS = adjusted net profit / efpowa*

ROA = adjusted ebit / average total assets

ROA Banks/Insurance = adjusted net profit / average total assets

ROE = adjusted net profit / average shareholders funds

Gross cashflow = adjusted net profit + depreciation

*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

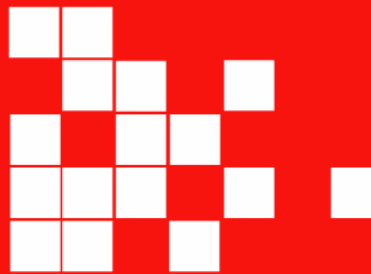
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Sales

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Michelle Paisley (China, Hong Kong)	(852) 2823 3516
Ulrike Pollak-Tsutsumi (Frankfurt)	(49) 69 7593 8747
Daniel Fust (Geneva)	(41) 22 818 7710
Thomas Renz (Geneva)	(41) 22 818 7712
Ajay Bhatia (India)	(9122) 6653 3200
Stuart Smythe (India)	(9122) 6653 3200
Eugene Ha (Korea)	(822) 3705 8643
K. Y. Nam (Korea)	(822) 3705 8607
Derek Wilson (London) (N Asia)	(44) 20 7065 5856
Julien Roux (London)	(44) 20 7065 5887
Lena Yong (Malaysia)	(603) 2059 8888
Ismael Pili (Philippines)	(65) 6231 2840
Greg Norton-Kidd (New York)	(1 212) 231 2527

Media

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Prem Jearajasingam (Malaysia)	(603) 2059 8989

Metals and Mining

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Rakesh Arora (India)	(9122) 6653 3054
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Oil and Gas

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Mark Barclay (Korea)	(822) 3705 8658
Edward Ong (Malaysia)	(603) 2059 8982
Kitti Nathisuwan (Taiwan)	(662) 694 7724

Pharmaceuticals

Shubham Majumder (India)	(9122) 6653 3049
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Property

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Eva Lee (Hong Kong, China)	(852) 2823 3573
Siddhartha Gupta (India)	(9122) 6653 3048
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Gilbert Lopez (Philippines)	(632) 857 0898
Tuck Yin Soong (Singapore)	(65) 6231 2838
Corinne Jian (Taiwan)	(8862) 2734 7529
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Technology

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George Chang (Japan)	(813) 3512 7854
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Do Hoon Lee (Korea)	(822) 3705 8641
Michael Bang (Korea)	(822) 3705 8659
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Daniel Chang (Taiwan)	(8862) 2734 7516
Dominic Grant (Taiwan)	(8862) 2734 7528
Jessica Chang (Taiwan)	(8862) 2734 7518
Nicholas Teo (Taiwan)	(8862) 2734 7523

Telecoms

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Jake Lynch (China, Hong Kong)	(852) 2823 3583
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Richard Moe (Indonesia)	(662) 694 7753
Nathan Ramler (Japan)	(813) 3512 7875
Joel Kim (Korea)	(822) 3705 8677
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Regional Heads of Sales cont'd

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Mark Lawrence (New York)	(1 212) 231 2516
Sheila Schroeder (San Francisco)	(1 415) 835 1235
Giles Heyring (Singapore)	(65) 6231 2888
Mark Duncan (Taiwan)	(8862) 2734 7510
Angus Kent (Thailand)	(662) 694 7601
Dominic Henderson (Tokyo)	(813) 3512 7820
Nick Cant (Tokyo)	(813) 3512 7821
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Rob Fabbro (UK/Europe)	(44) 20 7065 2031

Sales Trading

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Mona Lee (Hong Kong)	(852) 2823 3519
Stuart Goddard (Europe)	(44) 20 7065 2033
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Transport & Logistics

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Data Services

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Alternative Strategies

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Depository Receipts - Robert Ansell	(852) 2823 4688
Derivatives - Vipul Shah	(852) 2823 3523
Futures - Tim Smith	(852) 2823 4637
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