

SEPTEMBER 18, 2009

UPDATE

Coverage view: **Attractive**

Price (Rs): **866**

Target price (Rs): **860**

BSE-30: **16,741**

Innovator deal in the offing? DRRD shares have gained in the past couple of weeks following media speculation about a potential deal with an innovator company. We are unlikely to see a deal similar to the Daiichi-Ranbaxy one, but if a deal does take place, it could involve the purchase of the assets of an innovator company, leading to the issue of shares in DRRD. The recent run up is an opportunity to book profits for investors focused on absolute returns. Our estimates, target price and rating stay unchanged.

Company data and valuation summary

Dr Reddy's Laboratories

Stock data		Forecasts/Valuations			
		2009	2010E	2011E	
52-week range (Rs) (high,low)	900-355	EPS (Rs)	32.4	49.3	52.5
Market Cap. (Rs bn)	146.7	EPS growth (%)	24.3	52.2	6.4
Shareholding pattern (%)		P/E (X)	26.7	17.6	16.5
Promoters	25.8	Sales (Rs bn)	67.9	73.6	82.4
FIs	39.6	Net profits (Rs bn)	5.5	8.3	8.8
MFs	6.3	EBITDA (Rs bn)	13.7	16.1	17.1
Price performance (%)		EV/EBITDA (X)	11.8	9.4	8.4
Absolute	1M 3M 12M	ROE (%)	13.6	21.4	19.2
Rel. to BSE-30	(1.5) 1.3 32.8	Div. Yield (%)	0.7	0.8	0.9

Media talking of a potential deal with GSK

Economic Times reported in its Mumbai edition on Friday that GlaxoSmithKline (GSK) is in talks to pick up a 5% stake in DRRD to strengthen its association after signing a marketing alliance four months ago.

We think it may not be a straight equity share acquisition deal

We think that a deal with DRRD, if any, may be similar to the Aspen deal that GSK has concluded. DRRD could be interested in several GSK assets such as products in Indian/global markets, manufacturing facility that may come with a guaranteed outsourcing contract.

DRRD already has a deal with GSK for emerging markets excluding India

DRRD has entered into a partnership with GlaxoSmithKline plc (GSK) to develop and market products across emerging markets outside India. GSK will gain access to DRRD current portfolio and future pipeline of more than 100 branded pharmaceuticals in therapeutic segments such as cardiovascular, diabetes, oncology, gastroenterology and pain management.

Ratings, price target and estimates unchanged

DRRD is now near our target price but we continue with our BUY rating. This rating is relative rating to the Sensex.

QUICK NUMBERS

- ET talks of GSK taking 5% stake in DRRD
- Revenues of US\$20 mn from strategic alliance with GSK are in FY10 forecast
- Estimates and ratings are unchanged

Prashant Vaishampayan
prashant.vaishampayan@kotak.com
Mumbai: +91-22-6634-1127

Priti Arora
priti.arora@kotak.com
Mumbai: +91-22-6634-1551

Kotak Institutional Equities Research
kotak.research@kotak.com
Mumbai: +91-22-6634-1100

Media talks of a potential deal with GSK

Economic Times reports in its Mumbai edition on Friday that GlaxoSmithKline (GSK) is in talks to pick up a 5% stake in DRRD to strengthen its association after signing a marketing alliance four months ago.

Economic Times reports that the deal may be priced around US\$150 mn and could be completed in two months if talks stay on track—the paper quotes unnamed sources privy to the development. According to this report, GSK may acquire fresh shares of DRRD which will impact the founders' shareholding marginally and it may reserve the right of first refusal should the founder Reddy family (holder of 26% stake) decide to sell their stake in future.

Economic Times mentions that the persons close to the development said the Reddy family is not holding talks with anyone else. It adds further that the spokespersons for DRRD and GSK India separately declined to comment on market speculation. It mentions that GSK has effected a similar deal in May 2008 when it bought a 16% stake in South African pharma firm Aspen for US\$410 mn with which it had a marketing agreement.

GSK is increasing its emerging market presence in 2009

GSK has acquired the branded generics business of Bristol Myers Squibb (BMS) in Lebanon, Jordan, Syria, Libya and Yemen for a cash consideration of US\$23 mn. The business comprises a portfolio of 13 branded pharmaceuticals with annual sales in 2008 of US\$12 mn. This acquisition builds upon previous purchases of mature branded products in 2008 from BMS in Pakistan and Egypt, which included a manufacturing plant in Giza, Greater Cairo.

Why buy a 5% stake in DRRD?

We are trying to understand the reasons from GSK's perspective, to potentially own such a small stake in DRRD. Here we go back to the GSK deal in South Africa.

GSK divested eight specialist medicines to Aspen and a manufacturing facility located in Bad Oldesloe, Germany. In return, Aspen agreed to issue 68.5 mn new shares as non-cash consideration to GSK. These shares will be equivalent to a 16% shareholding in Aspen. Aspen will appoint GSK nominee to its Board of Directors.

We think that a deal with DRRD, if any, may be similar to the Aspen deal. There may be several GSK assets such as products in Indian/global markets, manufacturing facility that may come with a guaranteed outsourcing contract etc. that DRRD may be interested in.

Market reactions to an earlier acquisition rumor

On September 11, when Economic Times carried a similar report, DRRD shares rose on speculation that a leading global pharma firm is in talks with the Reddy family to buy a substantial stake in the company at a premium to the existing share price. This was immediately denied by DRRD and Reddy family. We believe that a deal similar to Daiichi-Ranbaxy for DRRD is a low probability event. This is especially true with GSK since it already has a strategic alliance that gives them access to DRRD products across emerging markets excluding India.

A deal to sell products in emerging markets ex-India

On June 15, 2009, DRRD has entered into a partnership with GlaxoSmithKline plc (GSK) to develop and market products across emerging markets outside India. GSK will gain access to DRRD current portfolio and future pipeline of more than 100 branded pharmaceuticals in therapeutic segments such as cardiovascular, diabetes, oncology, gastroenterology and pain management.

Earlier deal gives
DDRD access to
emerging markets

Financial details not shared by DRRD

The products will be manufactured by DRRD and will be licensed and supplied to GSK in various emerging markets such as Africa, the Middle East, Latin America and Asia Pacific excluding India. Revenues will be reported by GSK and will be shared with DRRD as per agreed terms. In certain markets, products will be co-marketed by DRRD and GSK. DRRD refused to share details of the potential revenues from this deal in the next two years.

This is a long-term positive for DRRD

It is a smart strategic move from DRRD to address its weakness in emerging markets, in our view. DRRD has been trying to expand its reach in international markets beyond US, Germany and Russia. DRRD reported revenues of Rs69 bn in FY2009 but only Rs8bn (about 12% of total revenues) came from emerging markets ex-India. DRRD earned revenues of about US\$12 mn each in Venezuela and Romania. It announced that it wants to add at least 3 markets with revenues of US\$12 mn per annum for the next three years. It also reduced presence in smaller and non-profitable markets inline with its strategy of profitable growth.

Multiple revenue streams are possible

Arrangement with GSK can help them earn revenues in following four ways. These are – old products in new markets (GSK adding to marketing muscle), old products in old markets, new products in old markets and new products in new markets. Here old products are the ones that DRRD has received approval for, old markets are the ones where DRRD already has marketing presence. GSK has been trying to enter emerging markets such as Turkey, South Africa and recently acquired assets in these markets. DRRD will be able to leverage from these GSK investments. Deal with DRRD gives them access to product portfolio which would have taken a long time to create.

Slow start in FY2011E, sharp increase in revenues to follow

In the absence of DRRD comments about revenue potential, we estimate that impact will be minimal in FY2010E as partners will be busy drafting new marketing strategy and will be waiting for approvals from healthcare authorities. We do not factor in any revenues in FY2010E but forecast US\$20 mn revenues with about 25% EBITDA margin in FY2011E. It is small in the first full year of operation but will increase sharply in FY2012E to US\$40 mn.

Valuation and share price movement

There has been a series of positive announcements from DRRD in 2009. These include generic Arixtra filing, crossing US\$150 mn revenues in Russia/CIS in FY2009, favorable summary judgment Omeprazole Mg OTC, ANDA approval for the same product and now the deal with GSK for emerging markets. An analyst meeting in May 2009 also provided investors with a roadmap of DRRD plans till FY2013E.

DRRD is now near our target price but we are still continuing with the BUY rating. This rating is a relative rating compared to Sensex. The quarter ending September 2009 will likely see a qoq decline in revenues as we factor in increasing competition for generic Imitrex in US. Launch of generic Prilosec OTC in that quarter may not be able to compensate for the negative impact of lower margin in generic Imitrex.

DRRD, Profit and loss statement, March fiscal year-ends, 2007-2011E

	2007	2008E	2009	2010E	2011E
Gross operating revenues	65,126	49,700	68,326	74,040	82,831
Excise duty	(897)	(558)	(422)	(405)	(466)
Net sales	64,229	49,142	67,904	73,635	82,366
Operating expenses					
Materials	(27,432)	(17,847)	(23,223)	(24,759)	(28,474)
Selling and administration	(9,735)	(10,561)	(15,514)	(17,950)	(20,180)
Employee cost	(6,433)	(7,311)	(9,920)	(10,751)	(11,826)
R&D	(2,446)	(3,447)	(4,093)	(4,573)	(5,354)
Others	(2,539)	(2,363)	(3,839)	(539)	0
Total expenditure	(48,584)	(41,528)	(56,589)	(58,572)	(65,833)
License fees and service income	910	775	1,102	420	0
EBITDA	16,555	8,389	12,417	15,483	16,532
Depreciation and amortisation	(3,791)	(4,019)	(4,977)	(4,931)	(5,400)
EBIT	12,764	4,370	7,440	10,552	11,132
Net finance cost	(1,526)	(958)	(972)	(647)	(500)
Other income	1,162	2,038	1,596	1,060	1,000
Pretax profits before extra-ordinaries	12,399	5,450	8,064	10,964	11,632
Current tax	(2,435)	(1,058)	(2,724)	(2,330)	(2,467)
Deferred tax	(238)	159	229	(325)	(325)
Fringe benefit tax	(71)	(178)	(113)	0	0
Reported net profit	9,656	4,373	5,456	8,310	8,841
Minority Interests	(4)	(9)	0	0	0
Reported net profit after minority interests	9,659	4,381	5,456	8,310	8,841
Exceptional item, expense/(profit)			14,628		
Reported net profit after minority interests and ex	9,659	4,381	(9,172)	8,310	8,841

Source: Kotak Institutional Equities, Company

DRRD, Breakup of profits (Rs mn)

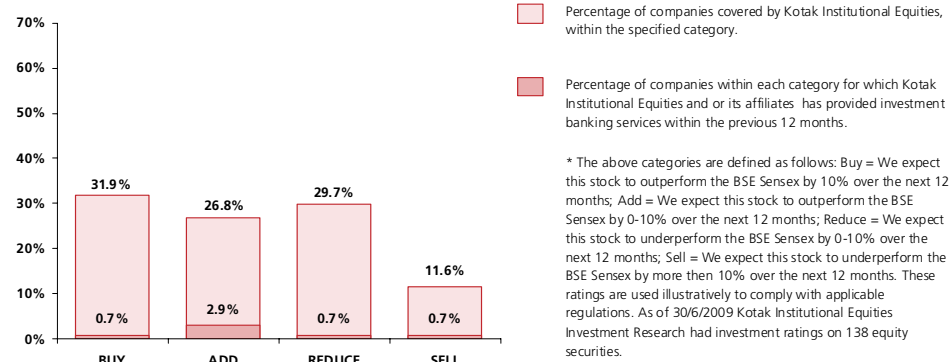
	FY2009	FY2010E	FY2011E		FY2009	FY2010E	FY2011E
Gross sales				PAT			
Base	51,283	59,604	67,502	Base	3,579	6,423	7,101
Imitrex/Omepazole/Arixtra	7,188	5,067	6,059	Imitrex/Omepazole/Arixtra	1,601	1,419	1,273
Betapharm	9,854	9,369	9,271	Betapharm	461	466	467
Total	68,325	74,040	82,831		5,641	8,307	8,841
EBITDA pre R&D				EPS (Rs)			
Base	11,489	15,890	17,700	Base	22.5	38.1	42.2
Imitrex/Omepazole/Arixtra	3,235	2,502	2,425	Imitrex/Omepazole/Arixtra	9.5	8.4	7.6
Betapharm	1,872	1,780	1,761	Betapharm	2.7	2.8	2.8
				One-time cost	(1.3)		
Total	16,596	20,172	21,886	Total (excl exceptional)	33.5	49.3	52.5
EBITDA, %				P/E (X)			
Base	22	27	26	Base	38.4	22.7	20.5
Imitrex/Omepazole/Arixtra	45	49	40	Base+Betapharm	34.3	21.2	19.3
Betapharm	19	19	19	Total	25.8	17.5	16.5
Total	24	27	26				

Source: Kotak Institutional Equities, Company

"I, Prashant Vaishampayan, hereby certify that all of the views expressed in this report accurately reflect my personal views about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report."

Kotak Institutional Equities Research coverage universe

Distribution of ratings/investment banking relationships



Source: Kotak Institutional Equities

As of June 30, 2009

Ratings and other definitions/identifiers

Definitions of ratings

BUY. We expect this stock to outperform the BSE Sensex by 10% over the next 12 months.

ADD. We expect this stock to outperform the BSE Sensex by 0-10% over the next 12 months.

REDUCE. We expect this stock to underperform the BSE Sensex by 0-10% over the next 12 months.

SELL. We expect this stock to underperform the BSE Sensex by more than 10% over the next 12 months.

Our target price are also on 12-month horizon basis.

Other definitions

Coverage view. The coverage view represents each analyst's overall fundamental outlook on the Sector. The coverage view will consist of one of the following designations: **Attractive, Neutral, Cautious.**

Other ratings/identifiers

NR = Not Rated. The investment rating and target price, if any, have been suspended temporarily. Such suspension is in compliance with applicable regulation(s) and/or Kotak Securities policies in circumstances when Kotak Securities or its affiliates is acting in an advisory capacity in a merger or strategic transaction involving this company and in certain other circumstances.

CS = Coverage Suspended. Kotak Securities has suspended coverage of this company.

NC = Not Covered. Kotak Securities does not cover this company.

RS = Rating Suspended. Kotak Securities Research has suspended the investment rating and price target, if any, for this stock, because there is not a sufficient fundamental basis for determining an investment rating or target. The previous investment rating and price target, if any, are no longer in effect for this stock and should not be relied upon.

NA = Not Available or Not Applicable. The information is not available for display or is not applicable.

NM = Not Meaningful. The information is not meaningful and is therefore excluded.

Corporate Office

Kotak Securities Ltd.
Bakhtawar, 1st Floor
229, Nariman Point
Mumbai 400 021, India
Tel: +91-22-6634-1100

Overseas Offices

Kotak Mahindra (UK) Ltd
6th Floor, Portsoken House
155-157 The Minories
London EC 3N 1 LS
Tel: +44-20-7977-6900 / 6940

Kotak Mahindra Inc
50 Main Street, Suite No.310
Westchester Financial Centre
White Plains, New York 10606
Tel:+1-914-997-6120

Copyright 2009 Kotak Institutional Equities (Kotak Securities Limited). All rights reserved.

Kotak Securities Limited and its affiliates are a full-service, integrated investment banking, investment management, brokerage and financing group. We along with our affiliates are leading underwriter of securities and participants in virtually all securities trading markets in India. We and our affiliates have investment banking and other business relationships with a significant percentage of the companies covered by our Investment Research Department. Our research professionals provide important input into our investment banking and other business selection processes. Investors should assume that Kotak Securities Limited and/or its affiliates are seeking or will seek investment banking or other business from the company or companies that are the subject of this material and that the research professionals who were involved in preparing this material may participate in the solicitation of such business. Our research professionals are paid in part based on the profitability of Kotak Securities Limited, which include earnings from investment banking and other business. Kotak Securities Limited generally prohibits its analysts, persons reporting to analysts, and members of their households from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover. Additionally, Kotak Securities Limited generally prohibits its analysts and persons reporting to analysts from serving as an officer, director, or advisory board member of any companies that the analysts cover. Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients that reflect opinions that are contrary to the opinions expressed herein, and our proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. In reviewing these materials, you should be aware that any or all of the foregoing, among other things, may give rise to real or potential conflicts of interest. Additionally, other important information regarding our relationships with the company or companies that are the subject of this material is provided herein.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of clients of Kotak Securities Limited. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice. The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide for future performance, future returns are not guaranteed and a loss of original capital may occur. Kotak Securities Limited does not provide tax advice to its clients, and all investors are strongly advised to consult with their tax advisers regarding any potential investment.

Certain transactions -including those involving futures, options, and other derivatives as well as non-investment-grade securities - give rise to substantial risk and are not suitable for all investors. The material is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. Opinions expressed are our current opinions as of the date appearing on this material only. We endeavor to update on a reasonable basis the information discussed in this material, but regulatory, compliance, or other reasons may prevent us from doing so. We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material, may from time to time have "long" or "short" positions in, act as principal in, and buy or sell the securities or derivatives thereof of companies mentioned herein. For the purpose of calculating whether Kotak Securities Limited and its affiliates holds beneficially owns or controls, including the right to vote for directors, 1% of more of the equity shares of the subject issuer of a research report, the holdings does not include accounts managed by Kotak Mahindra Mutual Fund. Kotak Securities Limited and its non US affiliates may, to the extent permissible under applicable laws, have acted on or used this research to the extent that it relates to non US issuers, prior to or immediately following its publication. Foreign currency denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of or income derived from the investment. In addition, investors in securities such as ADRs, the value of which are influenced by foreign currencies affectively assume currency risk. In addition options involve risks and are not suitable for all investors. Please ensure that you have read and understood the current derivatives risk disclosure document before entering into any derivative transactions.

This report has not been prepared by Kotak Mahindra Inc. (KMInc). However KMInc has reviewed the report and, in so far as it includes current or historical information, it is believed to be reliable, although its accuracy and completeness cannot be guaranteed. Any reference to Kotak Securities Limited shall also be deemed to mean and include Kotak Mahindra Inc.