

Muted Q3, positive triggers ahead

Cut forecasts and PO

Q3 reported profit at Rs2.7bn was 10% below estimates, due to lower-than-expected sales, weaker margins and non-recurring expense items. Sales rose 10%, at Rs19bn (est Rs 19.7bn) & Operating profit (adj.) rose 26%, at Rs3.1bn (est Rs 3.4bn). We cut profit our forecasts ~5%/year over FY11-13E & PO also by 5%, to Rs1910. Maintain our Buy on strong pipeline triggers & earnings growth.

Sales slightly below expectations

Q3 sales were affected by Russia (up 5% vs est. 18% growth) & domestic formulations (up 14%). Sales contraction in PSAI (5%, but up 8% qoq) & Europe (18%) was in line, as was the 60% yoy growth in US generics due to new products (Prevacid, Accolate, Valtrex). We expect improved traction in the US led by ramp up in OTC supplies (2 new customers) & likely new launches aided by strong regulatory pipeline of 32 Para IVs incl 12 FTFs (see table 3). Our revision to 16% CAGR (earlier 17%), however, moderate assumptions in Russia & Europe.

Margins slip on higher R & D expenses, one-offs

Q3 reported margin at 14.4% declined 166bps qoq, much lower than est of 17% due to higher R & D spend (7% of sales vs est 6%) as well as one-off charges. Adjusting for Rs405mn expenses pertaining to litigation & initial OTC ramp up spend in Russia, operating margins were at 16.5%. We therefore lower FY11-12E margin forecast by 70bps each year.

PO cut on core business, exclusivity triggers intact

Our PO of Rs1910 is a sum of parts of (1) base business value of Rs1840/sh at same 22x FY12E P/E, in line with large cap peers with similar growth (earlier Rs1950/sh) and (b) Retain NPV based value of exclusivities at Rs70/sh, which includes launches of generic Allegra D-24 (post litigation) & Arixtra in 4Q.

Estimates (Mar)

(Rs)	2009A	2010A	2011E	2012E	2013E
Net Income (Adjusted - mn)	6,533	8,612	11,149	18,638	17,636
EPS	38.78	50.72	65.66	109.76	103.86
EPS Change (YoY)	48.9%	30.8%	29.5%	67.2%	-5.4%
Dividend / Share	6.25	11.25	11.50	12.00	12.75
Free Cash Flow / Share	(96.64)	37.36	33.00	55.98	96.57
ADR EPS (US\$)	0.843	1.07	1.44	2.40	2.27
ADR Dividend / Share (US\$)	0.136	0.237	0.252	0.263	0.279

Valuation (Mar)

	2009A	2010A	2011E	2012E	2013E
P/E	40.71x	31.13x	24.05x	14.38x	15.20x
Dividend Yield	0.396%	0.713%	0.728%	0.760%	0.808%
EV / EBITDA*	21.00x	19.26x	16.72x	10.63x	10.68x
Free Cash Flow Yield*	-6.12%	2.37%	2.09%	3.55%	6.12%

* For full definitions of *iQmethod*SM measures, see page 6.

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Stock Data

Price (Common / ADR)	Rs1,579 / US\$36.56
Price Objective	Rs1,910 / US\$41.80
Date Established	25-Jan-2011 / 25-Jan-2011
Investment Opinion	C-1-7 / C-1-7
Volatility Risk	HIGH / HIGH
52-Week Range	Rs1,066-Rs1,855
Market Value (mn)	US\$5,821
Shares Outstanding (mn)	168.5 / 168.5
Average Daily Volume	404,562
BofAML Ticker / Exchange	DRYBF / BSE
BofAML Ticker / Exchange	RDY / NYS
Bloomberg / Reuters	DRRD IN / REDY.BO
ROE (2011E)	26.4%
Net Dbt to Eqty (Mar-2010A)	21.8%
Est. 5-Yr EPS / DPS Growth	25.0% / 12.0%
Free Float	74.2%

Key Changes

(Rs)	Previous	Current
Price Obj.	2,020.00	1,910.00
2011E Rev (m)	77,374.6	76,208.7
2012E Rev (m)	100,428.7	98,860.6
2013E Rev (m)	112,820.1	111,126.8
2011E EPS	69.59	65.66
2012E EPS	114.76	109.76
2013E EPS	107.39	103.86

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Refer to important disclosures on page 7 to 10. Analyst Certification on Page 5. Price Objective Basis/Risk on page 5. Link to Definitions on page 5. 11012757

25 January 2011

iQprofileSM Dr Reddy's Lab

Key Income Statement Data (Mar)	2009A	2010A	2011E	2012E	2013E
(Rs Millions)					
Sales	69,006	70,310	76,209	98,861	111,127
Gross Profit	31,782	30,959	34,402	47,912	51,503
Sell General & Admin Expense	(14,669)	(13,033)	(13,309)	(16,372)	(19,449)
Operating Profit	8,043	10,063	12,359	21,208	20,157
Net Interest & Other Income	23	702	605	849	838
Associates	NA	NA	NA	NA	NA
Pretax Income	8,065	10,765	12,964	22,056	20,995
Tax (expense) / Benefit	(2,608)	(2,668)	(1,815)	(3,419)	(3,359)
Net Income (Adjusted)	6,533	8,612	11,149	18,638	17,636
Average Fully Diluted Shares Outstanding	168	170	170	170	170

Key Cash Flow Statement Data

Net Income	5,457	8,097	11,149	18,638	17,636
Depreciation & Amortization	4,977	4,131	3,994	4,500	5,450
Change in Working Capital	(4,681)	4,709	(5,493)	(9,863)	(2,368)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(14,455)	(4,152)	1,211	2,580	2,531
Cash Flow from Operations	(8,703)	12,786	10,862	15,855	23,248
Capital Expenditure	(7,578)	(6,492)	(5,303)	(6,425)	(6,980)
(Acquisition) / Disposal of Investments	4,297	3,285	2,645	2,225	(6,351)
Other Cash Inflow / (Outflow)	NA	NA	NA	NA	NA
Cash Flow from Investing	(3,281)	(3,207)	(2,658)	(4,200)	(13,331)
Shares Issue / (Repurchase)	1	2	0	0	0
Cost of Dividends Paid	(1,053)	(1,910)	(1,953)	(2,038)	(2,165)
Cash Flow from Financing	(3,735)	(8,888)	(7,049)	(9,794)	(7,387)
Free Cash Flow	(16,281)	6,294	5,559	9,430	16,268
Net Debt	14,353	8,240	4,907	(1,897)	(6,854)
Change in Net Debt	16,011	(5,827)	(4,824)	(6,803)	(4,956)

Key Balance Sheet Data

Property, Plant & Equipment	16,334	17,373	20,804	23,728	24,759
Other Non-Current Assets	17,755	17,351	14,110	10,912	16,790
Trade Receivables	14,406	11,599	11,484	14,897	16,745
Cash & Equivalents	5,623	6,600	6,264	8,126	10,656
Other Current Assets	18,769	20,003	21,684	31,148	32,577
Total Assets	72,887	72,926	74,345	88,810	101,526
Long-Term Debt	19,976	14,840	11,170	6,228	3,802
Other Non-Current Liabilities	538	70	69	67	66
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	17,112	20,248	16,321	19,335	20,245
Total Liabilities	37,626	35,158	27,560	25,631	24,113
Total Equity	35,261	37,768	46,785	63,179	77,413
Total Equity & Liabilities	72,887	72,926	74,345	88,810	101,526

iQmethodSM - Bus Performance*

Return On Capital Employed	11.5%	14.0%	19.2%	28.1%	22.5%
Return On Equity	16.3%	23.6%	26.4%	33.9%	25.1%
Operating Margin	11.8%	14.7%	16.5%	21.8%	18.4%
EBITDA Margin	18.9%	20.2%	21.5%	26.0%	23.0%

iQmethodSM - Quality of Earnings*

Cash Realization Ratio	-1.3x	1.5x	1.0x	0.9x	1.3x
Asset Replacement Ratio	1.5x	1.6x	1.3x	1.4x	1.3x
Tax Rate (Reported)	32.3%	24.8%	14.0%	15.5%	16.0%
Net Debt-to-Equity Ratio	40.7%	21.8%	10.5%	-3.0%	-8.9%
Interest Cover	8.3x	32.2x	31.7x	NM	NM

Key Metrics

* For full definitions of iQmethodSM measures, see page 6.

Company Description

Dr. Reddy's is an emerging global pharmaceutical company with focus on the US, Europe, Russia and India. Dr. Reddy's recently acquired Betapharm in Germany to strengthen its foothold in the EU market. Finished dosage and API account for a bulk of the revenues, with up to 60% of sales derived from overseas operations. With a strong research pipeline, its R&D is focused in the areas of cancer, diabetes, cardiovascular, inflammation and bacterial infections.

Investment Thesis

We expect Dr. Reddy's to register robust revenue growth led by key markets of US, India and Russia/CIS. We expect margins to improve gradually, with scaleup in base business as well as upside from exclusivity opportunities. We are positive on DRL's ability to monetise its strong pipeline in US generics which may provide further upside to our forecasts. We believe current valuations do not factor potential earnings surprise ahead.

Stock Data

Shares / ADR	1.00
Price to Book Value	5.7x

Key Changes (ADR)

(US\$)	Previous	Current
Price Obj.	44.81	41.80
2011E EPS	1.52	1.44
2012E EPS	2.51	2.40
2013E EPS	2.35	2.27

3QFY11 results analysis

Table 1: Result highlights of Dr. Reddy's Laboratories, under IFRS reporting standards

	3QFY10	2QFY11	3QFY11	YoY	QoQ	Comments on 3QFY11 Results
Global Generics	11,724	13,667	13,589	16%	-1%	Strong US business led to robust growth in Generic formulation sales
North America	2,974	4,416	4,765	60%	8%	Strong growth of 60% YoY was muted due to impact of currency fluctuation. Constant currency growth of 66% was aided by recent new launches like generic Accolate, Prevacid, Valtrex, and Prograf.
Europe	2,579	2,366	2,123	-18%	-10%	Weak German business (down 33% YoY) was affected by price erosion in tender market environment. Rest of EU grew 39% YoY, to Rs744mn
India	2,632	3,160	3,007	14%	-5%	Modest 14% growth in domestic formulations largely driven by 8% volume growth of existing products and 16 new launches (40 launches YTD). Sequential growth of 14% is impressive as well
Russia/Row/CIS	3,539	3,725	3,694	4%	-1%	Gradual uptick in Russian market, however slower than expectations. Russian sales grew 11% in dollar terms, 7% in rupee terms at Rs2.4bn (up 4% sequentially). DRL showed 33% growth in volume terms vs industry growth of 12%. Other CIS markets de-grew 11%, to Rs434mn sales.
PSAI	5,238	4,617	4,980	-5%	8%	PSAI segment reported sluggish sales due to weakness in services segment (33% of total PSAI)
North America	722	814	770	7%	-5%	
Europe	2,152	1,551	1,830	-15%	18%	EU volumes started improving, impact of rationalisation of CRAMS business starting to show up on higher QoQ growth
India	607	653	622	2%	-5%	
Others	1,757	1,599	1,758	0%	10%	
Proprietary products	336	420	417	24%	-1%	
Total revenues	17,296	18,704	18,986	10%	2%	Overall revenues largely in line. Lower growth in Russia and India formulations was compensated by strong US sales
Cost of revenues	8,487	8,719	8,571	1%	-2%	Gross margins in line with our expectations.
Gross profit	8,809	9,985	10,415	18%	4%	Gross margins improved YoY as well as sequentially, thanks to niche launches in US generics
<i>Gross margin (%)</i>	<i>50.9%</i>	<i>53.4%</i>	<i>54.9%</i>	<i>393bps</i>	<i>147bps</i>	Gross margins for Global generics were at 65% (vs 60% last year) and 28% for PSAI (vs 31% last year)
SG&A expenses	5,057	5,392	6,066	20%	12%	Surge in S,G&A was due to one-time litigation cost as well as higher marketing spend for branded markets like Russia, India amounting to ~US\$9mn
% of Total Revenues	29%	29%	32%	271bps	312bps	
R&D Expenditure	892	1,270	1,306	46%	3%	Ramp up in regulatory filings, as reflected in rise in expenditure
% of Total Revenues	5%	7%	7%	172bps	9bps	Expect R&D cost to inch up on higher product filings to ~7% of sales
Amortization expenses	374	317	307	-18%	-3%	Amortisation expenses to be lower going forward as large part of intangibles got written off
% of Total Revenues	2%	2%	2%	(55bps)	(8bps)	
Operating income	2,486	3,006	2,737	10%	-9%	Impact of gross margin expansion of 393bps negated by high S,G&A spend (including one-off expenses)
<i>OPM (%)</i>	<i>14%</i>	<i>16.1%</i>	<i>14.4%</i>	<i>4bps</i>	<i>(166bps)</i>	Adjusted for one-time (US\$9mn spend), OPM was at 16.5% (slight improvement over 2Q).
Forex loss/(gain)	(44)	(49)	45	-202%	-192%	Forex loss on account of fluctuating currencies, especially rupee appreciation.
Other (expenses)/income net	262	274	198	-24%	-28%	
Finance expenses	(97)	(42)	(95)	-2%	126%	Gross debt was at Rs13.8bn (vs Rs14.5bn in Jun-10)
Equity in loss of affiliates	(2)	(3)	1	-135%	-123%	
Extraordinary expense/(income)	8,603	-	-	-100%		Represents impairment of intangibles and goodwill
Income before income taxes	(5,994)	3,192	2,884	-148%	-10%	PBT was 20% below estimates, thanks to weak EBITDA margins
Income tax (benefit)/expense	(777)	327	152	-120%	-54%	Tax rates lower than expected, leading to lower surprise at PAT level. To remain at 12% for FY11
Net income - reported	(5,217)	2,865	2,732	N.A.	-5%	Net profits 10% lower than forecasts, thanks to lower tax rate
Adjusted Net Profit	1,665	2,865	2,732	64%	-5%	

Source: Company reports, BofA-Merrill Lynch Research

Valuation comparables

Table 2: Indian Pharma coverage valuation comparables

Stock	ML Ticker	Rating	CMP Rs	Mkt Cap US\$mn	P/E (x)		EPS CAGR 10-12E	EV/EBITDA (x)		RoE (%)		EV/Sales (x)	
					FY11E	FY12E		FY11E	FY12E	FY11E	FY12E	FY11E	FY12E
Ranbaxy^	XIZZF	Neutral	564	5323	38.1x	19.6x	83%	24.9x	13.2x	29%	29%	3.5x	2.9x
Cipla	N.A.	Not rated	343	6089	24.4x	20.8x	10%	18.3x	15.7x	18%	18%	4.4x	3.8x
Sun Pharma	N.A.	Not rated	474	10781	27.7x	23.7x	24%	18.5x	15.8x	20%	19%	8.3x	6.7x
Dr Reddys	DRYBF	Buy	1579	5,902	25.9x	18.0x	39%	17.7x	13.0x	26%	34%	3.4x	2.6x
Lupin	LPMCF	Buy	467	4,608	24.5x	18.6x	28%	17.8x	13.7x	29%	30%	3.6x	3.0x
Large cap generics average					25.6x	20.3x	25%	18.1x	14.6x	23%	25%	4.9x	4.0x
Cadila	CDLHF	Buy	840	3,802	24.9x	19.1x	29%	17.2x	13.7x	35%	34%	4.1x	3.3x
Divis	XXQPF	Buy	631	1,848	17.6x	14.6x	19%	17.4x	12.9x	21%	24%	6.9x	5.4x
Glenmark	XVQWF	Buy	325	1,941	16.5x	14.8x	29%	10.8x	9.8x	11%	16%	3.2x	2.6x
Biocon	BCLTF	Buy	366	1,615	18.8x	13.6x	36%	11.3x	8.7x	20%	23%	2.5x	2.1x
GSK Pharma^	GXOLF	Underperform	2270	4,248	31.0x	27.2x	15%	21.0x	18.1x	29%	29%	7.5x	6.4x
IPCA	XBLAF	Buy	314	870	17.4x	12.9x	21%	11.7x	9.3x	24%	26%	2.4x	2.0x
India Pharma sector average (ex-Ranbaxy)					22.9x	18.3x	25%	16.2x	13.1x	23%	25%	4.6x	3.8x

Source: BofA - Merrill Lynch Global Research. ^ - Dec- ending, Bloomberg. For Dec ending companies, comparable data adjusted for Mar- ending

DRL's Para IV pipeline

Table 3: Upcoming product catalysts

Brand	Generic	Innovator	Branded sales US\$mn	Estimated launch	Remarks
Arixtra	Fondaparinux	GSK Plc	275	launched in Nov'10	Difficult product; only one other filer (recently filed); Expect limited competition over next 2-3 years
Prevacid	Lansoprazole	Takeda	1200	launched in Nov'10	Teva, Mylan, Sandoz are the only generic participants, DRL to see impact of full quarter sales in 4QFY11; expect limited competition for at least 15-18 months
Allegra D-24	Fexofenadine and Pseudoephedrine	Sanofi-Aventis	180	under litigation	DRL has sole FTF status; preliminary injunction has put launch status on hold. We expect launch in FY12 post liftment of PI
Accolate	Zafirlukast	Astra Zeneca	45	launched in Nov'10	Recent launch with Par Pharma (authorized generic) being the only competition, expect full impact from 4QFY11
Zyprexa	Olanzapine	Eli Lilly	750	Oct-11	DRL is the only filer in one strength; expect limited competition for 12-18 months
Geodon	Ziprasidone	Pfizer	1200	Mar-12	Shared FTF with Lupin
Lipitor	Atorvastatin	Pfizer	8000	May-12	Ranbaxy is the FTF, Teva, Watson and Mylan likely to be only other generic participants post exclusivity. DRL has not settled yet.
Nexium	Esomeprazole magnesium	Astra Zeneca	4500	May-14 or later	DRL to launch post exclusivity period of Ranbaxy

Source: USFDA, Company, BofA Merrill Lynch Global Research

Price objective basis & risk

Dr Reddy's Lab (DRYBF / RDY)

Our PO of Rs1910 (US\$41.8 for ADR) is based on the sum of (a) Rs1840/sh (US\$41.3/ADR) for base business (including known upside opportunities), valued at 22x FY12E EPS, in line with large cap Indian Pharma peers (Sun, Cipla), and (b) Rs70 (US\$1.5/ADR) for one-time exclusivity opportunity (generic Arixtra, Allegra D 24, Zyprexa, Geodon), valued on NPV basis.

Risks are: (a) delays in approval of niche filings in US Generics business, (b) slower-than-expected revival of domestic formulations business (c) higher-than-expected pain in Betapharm (Germany) operations, and (d) adverse impact of ruble exchange fluctuation.

Link to Definitions

Healthcare

Click [here](#) for definitions of commonly used terms.

Analyst Certification

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25 January 2011

India - Healthcare Coverage Cluster

Investment rating	Company	BofA Merrill Lynch ticker	Bloomberg symbol	Analyst
BUY				
	BIOCON LTD	BCLTF	BIOS IN	Arvind Bothra
	CADILA HEALTHCAR	CDLHF	CDH IN	Arvind Bothra
	Divi's Lab	XXQPF	DIVI IN	Arvind Bothra
	Dr Reddy's Lab	DRYBF	DRRD IN	S.Arun
	Dr Reddys Lab-A	RDY	RDY US	S.Arun
	Glenmark Pharm	XVQWF	GNP IN	Arvind Bothra
	IPCA Labs	XBLAF	IPCA IN	Arvind Bothra
	Lupin Limited	LPMCF	LPC IN	S.Arun
NEUTRAL				
	Ranbaxy Laboratories Limited	XIZZF	RBXY IN	S.Arun
UNDERPERFORM				
	GSK India	GXOLF	GLXO IN	Arvind Bothra
	Piramal Healthcare Ltd	XNIGF	PIHC IN	Arvind Bothra

iQmethodSM Measures Definitions

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	$\text{Total Assets} - \text{Current Liabilities} + \text{ST Debt} + \text{Accumulated Goodwill Amortization}$
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5-Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings		
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt, Less Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit		
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap. = Current Share Price * Current Basic Shares
Enterprise Value / Sales	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Other LT Liabilities}$	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

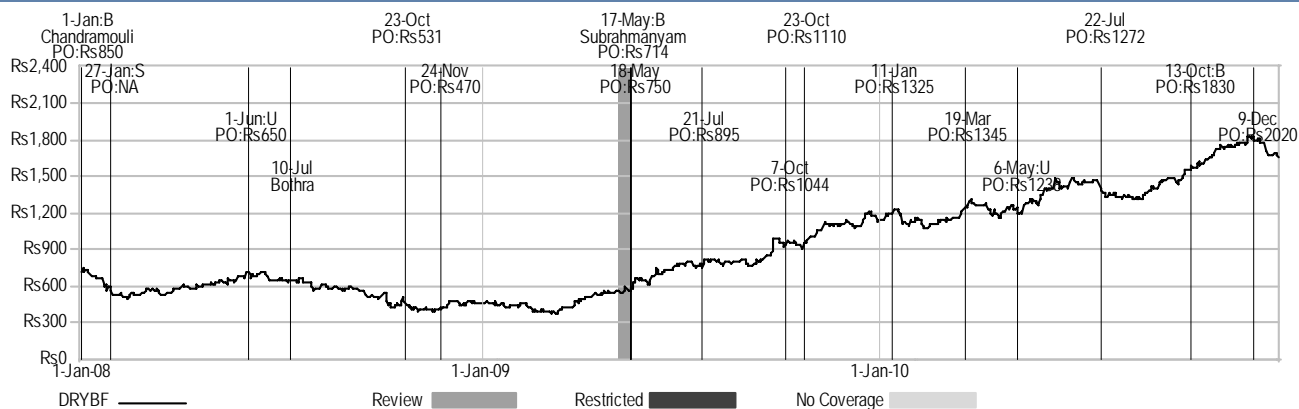
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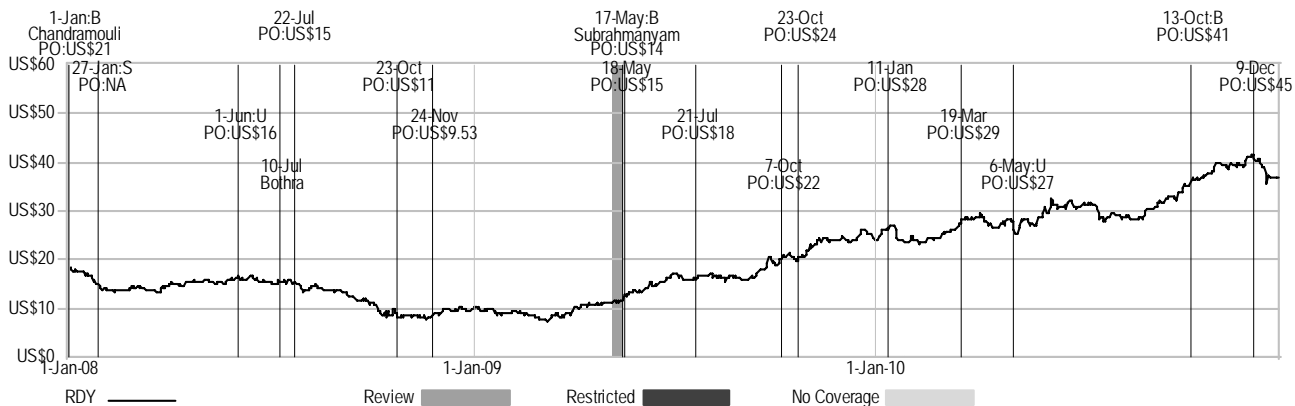
DRYBF Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid, NR: No Rating

Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of December 31, 2010 or such later date as indicated.

RDY Price Chart



B : Buy, N : Neutral, S : Sell, U : Underperform, PO : Price objective, NA : No longer valid, NR: No Rating

Prior to May 31, 2008, the investment opinion system included Buy, Neutral and Sell. As of May 31, 2008, the investment opinion system includes Buy, Neutral and Underperform. Dark Grey shading indicates that a security is restricted with the opinion suspended. Light grey shading indicates that a security is under review with the opinion withdrawn. The current investment opinion key is contained at the end of the report. Chart is current as of December 31, 2010 or such later date as indicated.

Investment Rating Distribution: Health Care Group (as of 01 Jan 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	127	54.51%	Buy	54	46.15%
Neutral	57	24.46%	Neutral	32	58.18%
Sell	49	21.03%	Sell	17	34.69%

Investment Rating Distribution: Global Group (as of 01 Jan 2011)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	2011	53.86%	Buy	874	48.31%
Neutral	925	24.77%	Neutral	444	52.30%
Sell	798	21.37%	Sell	276	36.75%

* Companies in respect of which BofA Merrill Lynch or one of its affiliates has received compensation for investment banking services within the past 12 months. For purposes of this distribution, a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where BofA Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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