May 13, 2009

ACTION

Buy

Dr. Reddy's Laboratories (REDY.BO)

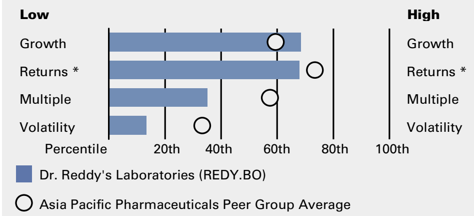
Return Potential: 37%

AOK supplies to start from June 2009; maintain Conviction Buy

Source of opportunity

We believe that commencement of supplies to AOK in Germany from next month could reduce market uncertainty on Betapharm, diminishing a key overhang on the stock. We reiterate our view that DRL's win of 17% of AOK tender volumes has enabled it to adapt to a changed volumes-based generic market in Germany and thus become a key generic player. Although DRL has risen strongly in recent months, we maintain the stock on our Conviction Buy List and our 12-m TP of Rs805 (potential upside of 35%). Any weakness around next week's 4Q results – which we expect to be characterized by write offs – should be used as a buying opportunity.

Investment Profile



* Returns = Return on Capital. For a complete description of the investment profile measures please refer to the disclosure section of this document.

Catalyst

We expect June's launch of supplies to AOK and subsequent quarterly results to provide **greater visibility on the volume/price dynamics of AOK supplies** and could allay market concerns on Betapharm. Other catalysts to support our 73% reported EPS growth estimates for FY10E include **potential FDA approvals of Omez OTC and Fondaparinux (Arixtra)**. With FDA recently placing Arixtra's ANDA on priority review, we believe DRL's chances of an accelerated approval are improved for a drug that is challenging to make and hence, enjoys higher than average margins.

Valuation

DRL is one of the least expensive stocks in our coverage group, trading at a **discount of 18% on one-year forward P/E of 12.6X and 19% on one-year forward EV/EBITDA of 7.9X to its peers** (ex-Ranbaxy). We believe this is a reflection of market uncertainty over Germany and Russia. Our 12-m TP of Rs805 implies FY10E P/E of 17.0X, which is a 26% premium over the sector's TP implied P/E. We believe this is justified due to its higher earnings potential (**3-yr EPS CAGR of 41% vs peers' avg. of 20%**).

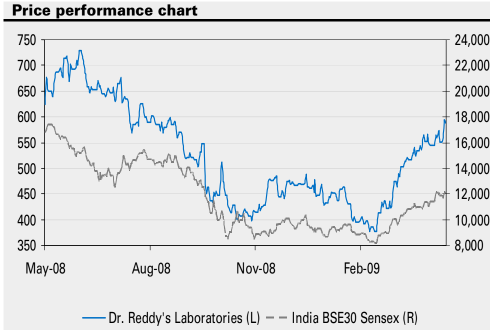
Key risks

1) Currency volatility (especially Ruble) (2) domestic market slowdown.

Key data	Current
Price (Rs)	587.65
12 month price target (Rs)	805.00
Market cap (Rs mn / US$ mn)	98,666.4 / 2,000.5
Foreign ownership (%)	3,044.0

	3/08	3/09E	3/10E	3/11E
EPS (Rs)	26.09	27.43	47.34	61.19
EPS growth (%)	(56.9)	5.1	72.6	29.3
EPS (diluted) (Rs)	26.09	27.43	47.34	61.19
EPS (basic pre-ex) (Rs)	26.09	27.43	47.34	61.19
P/E (X)	22.5	21.4	12.4	9.6
P/B (X)	2.2	2.0	1.8	1.5
EV/EBITDA (X)	13.9	9.5	7.2	5.7
Dividend yield (%)	0.7	0.8	0.9	1.0
ROE (%)	10.3	9.8	15.2	16.9

Price performance chart



Share price performance (%)	3 month	6 month	12 month
Absolute	36.3	42.0	(5.9)
Rel. to India BSE30 Sensex	9.2	12.7	31.2

Source: Company data, Goldman Sachs Research estimates, FactSet. Price as of 5/13/2009 close.

INVESTMENT LIST MEMBERSHIP

Asia Pacific Buy List

Asia Pacific Conviction Buy List

Coverage View: Neutral

India:
Pharmaceuticals

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Dr. Reddy's Laboratories: Summary financials

Profit model (Rs mn)	3/08	3/09E	3/10E	3/11E
Total revenue	**49,141.7**	**65,564.2**	**72,185.7**	**83,013.5**
Cost of goods sold	(22,752.6)	(35,028.1)	(32,595.6)	(36,856.2)
SG&A	(19,330.1)	(19,013.6)	(25,445.4)	(29,262.3)
R&D	(3,447.1)	(3,933.9)	(4,331.1)	(4,980.8)
Other operating profit/(expense)	975.2	(819.6)	180.5	207.5
EBITDA	**8,605.7**	**11,572.1**	**14,004.0**	**16,104.6**
Depreciation & amortization	(4,018.6)	(4,803.0)	(4,010.1)	(3,982.9)
EBIT	**4,587.0**	**6,769.1**	**9,993.9**	**12,121.7**
Interest income	755.0	745.3	848.2	1,806.4
Interest expense	(958.3)	(1,398.5)	(1,398.5)	(1,398.5)
Income/(loss) from uncons. subs.	(16.7)	0.0	0.0	0.0
Others	0.0	(500.0)	250.0	0.0
Pretax profits	**5,449.6**	**5,615.8**	**9,693.6**	**12,529.6**
Income tax	(1,076.9)	(1,010.8)	(1,744.8)	(2,255.3)
Minorities	8.7	0.0	0.0	0.0
Net income pre-preferred dividends	**4,381.3**	**4,605.0**	**7,948.7**	**10,274.3**
Preferred dividends	0.0	0.0	0.0	0.0
Net income (pre-exceptionals)	**4,381.3**	**4,605.0**	**7,948.7**	**10,274.3**
Post-tax exceptionals	0.0	0.0	0.0	0.0
Net income	**4,381.3**	**4,605.0**	**7,948.7**	**10,274.3**
EPS (basic, pre-except) (Rs)	26.09	27.43	47.34	61.19
EPS (basic, post-except) (Rs)	26.09	27.43	47.34	61.19
EPS (diluted, post-except) (Rs)	26.09	27.43	47.34	61.19
DPS (Rs)	4.40	4.84	5.32	5.85
Dividend payout ratio (%)	16.9	17.6	11.2	9.6
Free cash flow yield (%)	(0.4)	1.2	10.1	9.7

Growth & margins (%)	3/08	3/09E	3/10E	3/11E
Sales growth	(23.6)	33.4	10.1	15.0
EBITDA growth	(48.9)	34.5	21.0	15.0
EBIT growth	(64.9)	47.6	47.6	21.3
Net income growth	(54.6)	5.1	72.6	29.3
EPS growth	(57.2)	5.1	72.6	29.3
Gross margin	53.7	46.6	54.8	55.6
EBITDA margin	17.5	17.7	19.4	19.4
EBIT margin	9.3	10.3	13.8	14.6

Cash flow statement (Rs mn)	3/08	3/09E	3/10E	3/11E
Net income pre-preferred dividends	4,381.3	4,605.0	7,948.7	10,274.3
D&A add-back	4,018.6	4,803.0	4,010.1	3,982.9
Minorities interests add-back	0.0	0.0	0.0	0.0
Net (inc)/dec working capital	(2,269.6)	(4,690.7)	1,683.7	(1,236.4)
Other operating cash flow	323.2	(500.0)	250.0	0.0
Cash flow from operations	**4,825.1**	**4,717.3**	**13,642.5**	**13,020.7**
Capital expenditures	(5,085.8)	(2,950.4)	(3,248.4)	(3,735.6)
Acquisitions	(16,204.2)	0.0	0.0	0.0
Divestitures	12,537.1	0.0	0.0	0.0
Others	0.0	0.0	0.0	0.0
Cash flow from investments	**(8,752.9)**	**(2,950.4)**	**(3,248.4)**	**(3,735.6)**
Dividends paid (common & pref)	(736.9)	(738.4)	(812.3)	(893.5)
Inc/(dec) in debt	(6,074.3)	0.0	0.0	0.0
Common stock issuance (repurchase)	15.2	0.0	0.0	0.0
Other financing cash flows	0.0	0.0	0.0	0.0
Cash flow from financing	**(6,796.0)**	**(738.4)**	**(812.3)**	**(893.5)**
Total cash flow	**(10,723.9)**	**1,028.5**	**9,581.9**	**8,391.6**

Balance sheet (Rs mn)	3/08	3/09E	3/10E	3/11E
Cash & equivalents	7,452.9	8,481.7	18,063.6	26,455.2
Accounts receivable	6,521.7	8,701.1	9,579.9	11,016.9
Inventory	11,018.8	16,963.6	15,785.6	17,849.0
Other current assets	5,349.0	5,349.0	5,349.0	5,349.0
Total current assets	**30,342.4**	**39,495.5**	**48,778.1**	**60,670.1**
Net PP&E	15,163.2	16,310.5	17,573.8	19,026.5
Net intangibles	26,640.0	23,640.0	21,615.0	19,915.0
Total investments	5,006.4	5,006.4	5,006.4	5,006.4
Other long-term assets	0.0	0.0	0.0	0.0
Total assets	**77,152.0**	**84,452.5**	**92,973.4**	**104,618.1**
Accounts payable	10,274.6	13,708.3	15,092.7	17,356.6
Short-term debt	688.7	688.7	688.7	688.7
Other current liabilities	795.6	796.0	796.0	796.0
Total current liabilities	**11,758.9**	**15,192.9**	**16,577.4**	**18,841.3**
Long-term debt	18,995.2	18,995.2	18,995.2	18,995.2
Other long-term liabilities	1,429.0	1,429.0	1,429.0	1,429.0
Total long-term liabilities	20,424.2	20,424.2	20,424.2	20,424.2
Total liabilities	**32,183.2**	**35,617.2**	**37,001.6**	**39,265.5**
Preferred shares	**0.0**	**0.0**	**0.0**	**0.0**
Total common equity	**44,968.8**	**48,835.4**	**55,971.8**	**65,352.6**
Minority interest	0.0	0.0	0.0	0.0
Total liabilities & equity	**77,152.0**	**84,452.5**	**92,973.4**	**104,618.1**
BVPS (Rs)	**267.83**	**290.86**	**333.36**	**389.24**

Ratios	3/08	3/09E	3/10E	3/11E
ROE (%)	10.3	9.8	15.2	16.9
ROA (%)	5.7	5.7	9.0	10.4
ROACE (%)	8.8	8.8	14.3	17.1
Inventory days	148.3	145.8	183.4	166.5
Receivables days	53.2	42.4	46.2	45.3
Payable days	161.0	125.0	161.3	160.7
Net debt/equity (%)	27.2	22.9	2.9	(10.4)
Interest cover - EBIT (X)	22.6	10.4	18.2	NM

Valuation	3/08	3/09E	3/10E	3/11E
P/E (analyst) (X)	22.5	21.4	12.4	9.6
P/B (X)	2.2	2.0	1.8	1.5
EV/EBITDA (X)	13.9	9.5	7.2	5.7
Dividend yield (%)	0.7	0.8	0.9	1.0

Note: Last actual year may include reported and estimated data.

Source: Company data, Goldman Sachs Research estimates.

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Betapharm overhang still leaves potential upside; reiterate Buy

In our note of Feb 25, we looked at Dr Reddy's prospects for FY2010 in all of its four key markets and reiterated our Buy rating (Conviction List), with **forecasts of 10% revenue growth and reported EPS growth of 73%. For FY2010E, w**hile there still exist concerns over DRL's Russian exposure and German business, we analyze incremental data points on these geographies and their impact on DRL's business.

We **believe that commencement of supplies to AOK in Germany from next month could reduce market uncertainty on Betapharm**, diminishing a key overhang on the stock. We reiterate our view that DRL's win of 17% of AOK's tender volume has enabled it to adapt to a changed environment in Germany, where volumes play a greater importance, thus making it a long-term player of significance.

We believe next month's launch of supplies to AOK and subsequent quarterly results will provide **greater visibility on the volume/price dynamics of supplying to AOK** and could allay market concerns on Betapharm. As far as Russia is concerned, we believe that DRL is well-placed to benefit from Russian market potential and relatively sheltered from liquidity risk from creditors, given that its products are distributed by four of the country's leading distributors.

Although the stock has moved up strongly in recent months we retain it on our Conviction Buy List and our TP of Rs805 (potential upside of 35%). Any **weakness around next week's 4Q results** – which we expect to be characterized by write offs – **should be used as a buying opportunity.**

Other catalysts to support our estimate of 73% reported EPS growth for FY10E include **potential FDA approvals of Prilosec OTC and Fondaparinux (Arixtra) in the near-term**. With the USFDA placing Arixtra's ANDA on a priority review pathway on May 11, we believe that DRL's chances of an accelerated approval are improved for a drug that is difficult to make and which enjoys higher than average margins.

AOK clears legal hurdles; to commence procurement from Jun'09

We added DRL to our Conviction Buy List in December 2008 and noted as a key catalyst that DRL's German subsidiary was better placed to win AOK tenders, than the earlier AOK tender bids in 2006.

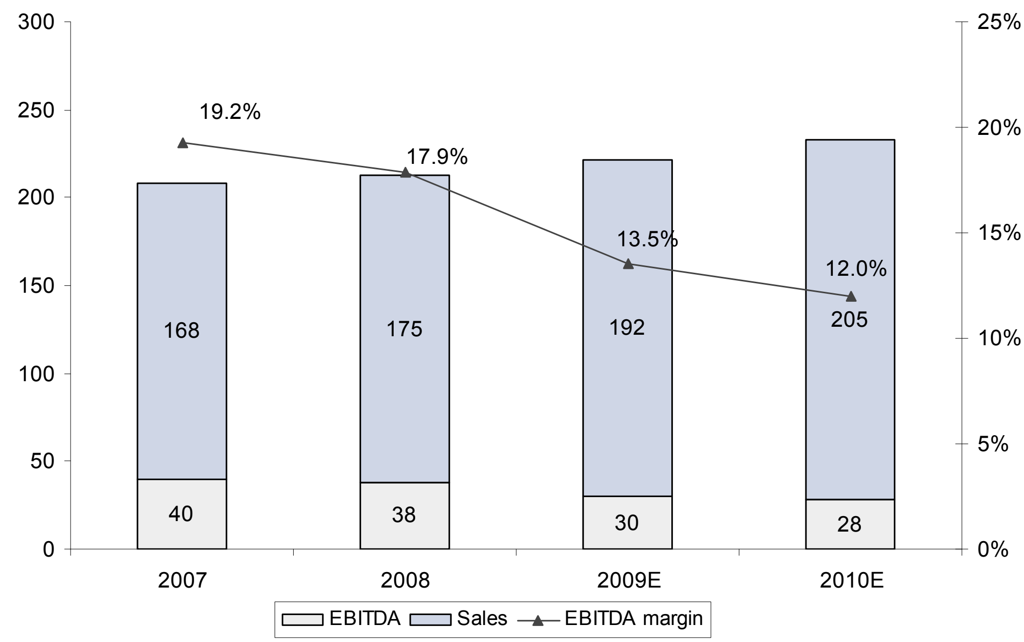
However, following DRL's win of 17% of AOK tender volumes, there have been concerns in the market on

- revenue growth, owing to the low priced generics business of AOK and
- EBIT margins and profitability as margins in the generics business are significantly lower than the branded, prescription driven business.

AOK recently announced that it can go ahead from June 2009 with most of the 2.3bn Euros ($3.1 bn) worth of bulk procurement contracts for generics it has tendered after clearing the legal hurdles it faced in Germany. This includes the 17% of AOK tender volume that DRL has won (third largest share of volume wins) and we expect DRL to begin supplying from June.

In our view, the initial period of supplying AOK products could necessitate a phase of de-stocking of those products which have not been won through the AOK tender . Also, as supply of the volumes to AOK starts in June and the process gets streamlined in the initial phase, **we estimate relatively flat growth in the German market in the first year** of the tender process (FY2010E).

Exhibit 1: We do not expect net EU Generic sales to decline for FY10E, as greater volume sales could sustain the topline; though EBITDA margins could decline by 150 bps



Source: Company data, Goldman Sachs Research estimates.

Steps taken by DRL to control costs could help mitigate margin impact.

Although the low-margin generic business could sustain the topline, we estimate the net impact on EBITDA margins to be around 150bps. We believe that the company's focus on controlling costs on two fronts helps mitigate the negative impact on margins. The company plans to:

1) **Continue transfer of additional products** to be manufactured out of India, thus reducing the cost of manufacturing. Currently the company states that it has moved the production of most of its top 15 products in Germany to the Betapharm dedicated facility in India.

2) **Reduce sales force head count to save around 16mn Euros**: as the volumes-based generic model of supplying to AOK does not require any sales personnel. Currently around 120 sales personnel promote Betapharm's products in the German market. As AOK covers around 40% of this market and DRL would not need any sales force for this market, we expect a proportionate reduction in sales force by around 48-50 personnel. We estimate this to provide cost savings of around 16mn – 18mn Euros for Betapharm.

Net Impact to be minimal – Betapharm's EBITDA margins could decline by 150 bps

Hence, we estimate the net impact of the low margin and high volume AOK tender business to be minimal in the first year, with revenues being sustained while margins could decline by 150bps for FY2010E. We believe next month's AOK launch and subsequent quarterly results will provide greater visibility on the volume/price dynamics of supplying to AOK and could allay market concerns on Betapharm.

Cumulatively, we estimate the negative impact on EBITDA margins translates to an EPS impact of around Rs0.95 (2.0% of FY10 EPS).

Russia: Scope for price rise; improvement in receivable days

The Russia and CIS segment, which constitutes around 12% of our forecast revenues for DRL has been a rapid growth area for the company. At the 11-month stage in FY09E, DRL had posted 24% growth in USD (or 38% growth in Rupees). However, macro economic conditions and Ruble depreciation have raised concerns over receivables.

The company recently stated that it has not seen any deterioration in receivables, and in fact has been experiencing a reduction in receivables day, which have declined by 7 days. We believe that this is a function of the fact that DRL deals with four of the largest distributors in Russia (Avesta, Protek, Sia and Katren) and hence, is relatively well placed.

Additionally, the company has stated that unlike most Eastern European Generics producers, which enjoy significantly higher prices in the Russian generic market, it **has a significantly higher scope to increase price**. As a result, since the onset of Ruble devaluation, DRL has renegotiated prices with its distributors, charging them in Rubles with a markup. The company says that it has increased its prices by an average of 20% for most of the top products its sells in Russia.

In our view, this has led to relatively stable, 20% plus growth in the Russian market over the last few quarters, despite the Ruble depreciating by 20% in the last six months. However, as stated before in our note of Feb 25, we still expect the net impact in FY10E to be lower revenue growth from the Russian market and **forecast 14% growth in the Russia /CIS segment**, compared to the 39% growth that we expect for FY2009E.

Catalysts – Arixtra in FDA priority review; potential approval near-term

Progress on Arixtra ANDA; FDA accepts it for priority review under GIVE on May 11

DRL's partner on Fondaparinux, Alchemia Ltd, announced on May 11 that its global manufacturing and US marketing partner DRL, has received notice of acceptance of its ANDA for Fondaparinux (marketed by GSK under the brand name of **Arixtra; global sales of US$315 mn; US sales of US$ 180mn** in 2008).

DRL was the first generic firm to file an ANDA for this product in March 2009, and the acceptance by the FDA implies that the ANDA application would not enter a period of formal review. Instead, this would be taken onto the priority review pathway under FDA's GIVE initiative (Generic Initiative for Value and Efficiency) owing to its primal status. Owing to this, we believe US FDA approval on this product could come through in the next four to six months.

Fondaparinux's complex manufacturing process implies higher margins for DRL

In our view, DRL's manufacturing skills (process is developed by Alchemia) are also validated further by this ANDA, as it is a complex molecule to produce. This in our view also explains the lack of generic versions of this product in the market. Consequently, we believe that DRL would benefit from higher-than-industry average margins on this product. In the event of an approval, and assuming DRL launches this product for 6 months during FY2010E, we **estimate a net income contribution of US$4.5 mn from Fondaparinux**.

Potential approval on Prilosec OTC in the near future

Another near-term catalyst, which we have highlighted before, is potential FDA approval of DRL's ANDA on a generic version of Prilosec OTC. It is to be noted that the US District Court ruled in favour of DRL in its summary judgment in March 2009, and we believe that DRL could launch its generic Omeprazole OTC as soon as it receives US FDA approval.

Along with Perrigo, DRL could be only the second generic company with Omez OTC and thus could generate around US$20-30mn in revenues from this product launch.

Valuation opportunity owing to concerns on Germany / Russia

Our 12-month target price of Rs805 is derived using a DCF methodology with a comparative analysis of four other ratios as a reality check.

Dr Reddy's is one of the **least expensive stocks in our coverage group** and trades at a significant **discount of 18% on one-year forward PE of 12.6X** and 19% on one-year forward EV/EBITDA of 7.9X to its peers (ex-Ranbaxy).

We believe the discounted multiples that Dr Reddy's trades at are a reflection of the market's uncertainty over its growth prospects related to the impact of the AOK tender on Betapharm in a changing business environment in Germany, and receivables risk in Russia.

We believe that the low 3-year PEG of 0.5 indicates the higher earnings potential of the company (compared to the peer average of 1.6) and maintain DRL on our Conviction Buy List. Our 12-month target price of Rs805 implies a FY10E P/E of 17.0X, a 26% premium over our sector's TP implied P/E. We believe this premium is justified owing to the higher earnings potential of the company (i.e., 41% 3-year EPS CAGR for DRL vs 20% for peers).

Exhibit 2: DRL trades at 18%/19% discount on one-year forward PE and EV/EBITDA to its peers
12-month target prices for our coverage group; reality check vs. four other ratios

Goldman Sachs India Healthcare Coverage					Price		Potential	One year Forward (x)			TP	GS 3 yr CAGR	
	Ticker	M Cap ($mn)	Free float	Rating	Current (Rs)	12-mth TP (Rs)	upside / downside	P/E	EV / EBITDA	3 yr PEG	implied P/E (x)	Sales	EPS
Dr Reddys	REDY.BO	2023	66%	Buy*	594	805	35%	12.6	7.9	0.5	17.0	13%	41%
Versus coverage group								-18%	-19%				
Lupin	LUPN.BO	1290	43%	Buy	775	870	12%	12.5	8.0	0.7	14.0	19%	22%
Versus coverage group								-18%	-18%				
Ranbaxy	RANB.BO	1327	35%	Sell	176	118	-33%	nm	36.4	nm	-6.9	20%	
Versus coverage group													
Cipla	CIPL.BO	3473	58%	Sell	220	158	-28%	20.8	15.1	1.4	14.9	16%	20%
Versus coverage group								37%	54%				
Sun Pharmaceuticals	SUN.BO	5025	34%	Neutral	1301	1076	-17%	18.1	15.0	4.2	14.9	10%	4%
Versus coverage group								19%	53%				
Biocon	BION.BO	589	30%	Neutral	150	122	-19%	21.0	9.0	1.2	17.0	13%	22%
Versus coverage group								38%	-9%				
Cadila	CADI.BO	886	21%	Neutral	322	281	-13%	13.0	8.1	1.4	11.4	10%	10%
Versus coverage group								-14%	-17%				
Glenmark	GLEN.BO	842	42%	Neutral	174	149	-15%	8.0	5.5	0.4	6.8	15%	26%
Versus coverage group								-47%	-44%				
Piramal Healthcare	PIRA.BO	1065	36%	Neutral	251	210	-16%	15.9	9.7	1.1	13.3	11%	17%
Versus coverage group								4%	-1%				
Coverage group average (ex-Ranbaxy)								**15.2**	**9.8**	**1.6**	**13.7**	**14%**	**20%**

All target prices based on DCF, with the exception of Glenmark and Ranbaxy target prices which are based on one year forward P/E.

**This stock is on our regional Conviction Buy list.*

Risks: (1) The companies in our coverage group derive about 65% of their revenues from overseas. This makes our coverage group vulnerable to the translational impact of the strengthening rupee; (2) We believe the Indian pharma sector is also vulnerable to adverse amendments to domestic drug price policy.
For important disclosures, please go to http://www.gs.com/research/hedge.html.

Source: Datastream, Company data, Goldman Sachs Research estimates.

Reg AC

We, Vikram Sahu and Balaji V. Prasad, hereby certify that all of the views expressed in this report accurately reflect our personal views about the subject company or companies and its or their securities. We also certify that no part of our compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

Investment profile

The Goldman Sachs Investment Profile provides investment context for a security by comparing key attributes of that security to its peer group and market. The four key attributes depicted are: growth, returns, multiple and volatility. Growth, returns and multiple are indexed based on composites of several methodologies to determine the stocks percentile ranking within the region's coverage universe.

The precise calculation of each metric may vary depending on the fiscal year, industry and region but the standard approach is as follows:

Growth is a composite of next year's estimate over current year's estimate, e.g. EPS, EBITDA, Revenue. **Return** is a year one prospective aggregate of various return on capital measures, e.g. CROCI, ROACE, and ROE. **Multiple** is a composite of one-year forward valuation ratios, e.g. P/E, dividend yield, EV/FCF, EV/EBITDA, EV/DACF, Price/Book. **Volatility** is measured as trailing twelve-month volatility adjusted for dividends.

Quantum

Quantum is Goldman Sachs' proprietary database providing access to detailed financial statement histories, forecasts and ratios. It can be used for in-depth analysis of a single company, or to make comparisons between companies in different sectors and markets.

Disclosures

Coverage group(s) of stocks by primary analyst(s)

Vikram Sahu: India Pharmaceuticals. Balaji V. Prasad: India Pharmaceuticals.

India Pharmaceuticals: Apollo Hospitals, Biocon, Cadila Healthcare, Cipla, Dr. Reddy's Laboratories, Fortis Healthcare, Glenmark Pharmaceuticals, Lupin, Piramal Healthcare, Ranbaxy Laboratories, Sun Pharmaceutical Industries.

Company-specific regulatory disclosures

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Goldman Sachs expects to receive or intends to seek compensation for investment banking services in the next 3 months: Dr. Reddy's Laboratories (Rs587.65)

Distribution of ratings/investment banking relationships

Goldman Sachs Investment Research global coverage universe

	Rating Distribution			Investment Banking Relationships		
	Buy	Hold	Sell	Buy	Hold	Sell
Global	25%	53%	22%	54%	51%	43%

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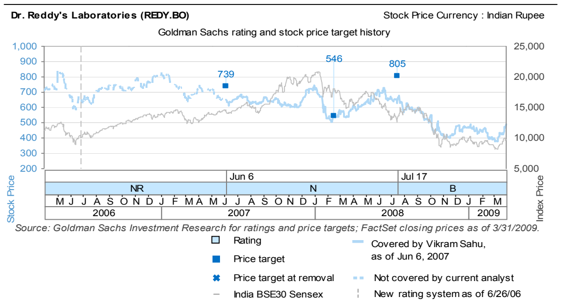
Price target and rating history chart(s)



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