

Stellar 4Q; Upbeat core outlook



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Upbeat base business outlook; Betapharm concerns allayed

DRL's stellar 4Q net profit of Rs3.25bn (80% ahead of Mle) was driven by significant one-offs - generic Zofran and Aciphex API supply. Adjusted for this, we estimate 4Q core revenue growth of 64% YoY (Rs11.3bn) and sharp 10% gross margin increase (to 52% YoY) and 4Q PAT at Rs1.3-1.4bn. (adj. for intangibles write-down). We maintain our Buy rating, noting strong core outlook, resolution of supply issues in Betapharm and attractive valuations. We revise our PO from Rs1059 given lower EPS estimates to Rs850/share, which offers 27.7% upside potential.

Lower EPS reflects conservative Betapharm outlook

We have lowered our FY08E and FY09E earnings estimates by 13.7% and 6.6% respectively to factor in the changing business environment and a more conservative outlook on Betapharm due to regulatory and pricing pressures in the German market. Our estimates are, however, 6% and 13% higher than the consensus on FY08E and FY09E earnings.

Balaglitazone and R&D progress promising

DRL expects to begin Phase III pivotal clinical studies for Balaglitazone shortly after end of Phase II studies meeting with USFDA and EMEA in next few months. Further, DRL has applied for orphan drug exclusivity status for DRF1042 (cancer) on which an outcome is possible shortly thereby facilitating accelerated studies.

Management conference call key highlights

(a) Overall growth expectation for Betapharm in FY08E; likely 10 product switches to India site which will deliver significant cost savings starting FY08E (b) FY08E to reflect significant gross margin increase to 50-52% range vs. 47% gross margin in FY07 (c) Significant reduction in debt/equity to 59% vs. 150% in 2006.

Estimates (Mar)

(Rs)	2005A	2006A	2007E	2008E	2009E
Net Income (Adjusted - mn)	211.70	1,467	9,658	6,573	8,296
EPS	1.27	8.78	57.80	39.34	49.65
EPS Change (YoY)	NA	593.2%	558.2%	-31.9%	26.2%
Dividend / Share	4.00	5.00	5.00	5.00	5.00
Free Cash Flow / Share	(1.27)	(21.50)	38.31	54.28	55.63
ADR EPS (US\$)	0.028	0.199	1.33	0.963	1.22
ADR Dividend / Share (US\$)	0.089	0.113	0.115	0.122	0.122

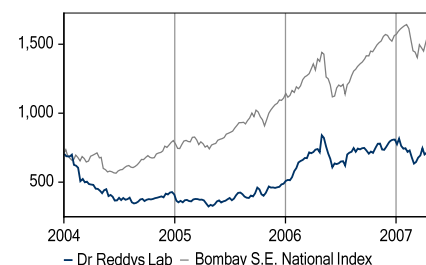
Valuation (Mar)

	2005A	2006A	2007E	2008E	2009E
P/E	525.51x	75.81x	11.52x	16.92x	13.41x
Dividend Yield	0.601%	0.751%	0.751%	0.751%	0.751%
EV / EBITDA*	117.99x	32.97x	6.24x	8.31x	7.10x
Free Cash Flow Yield*	-0.190%	-3.23%	5.75%	8.15%	8.36%
EV / Sales	5.58x	4.42x	1.61x	1.89x	1.62x

* For full definitions of *iQmethod*SM measures, see page 8.

Stock Data

Price (Common / ADR)	Rs665.75 / US\$16.20
Price Objective	RS1059 to Rs850.00 / US\$23.95 to US\$20.88
Date Established	21-May-2007 / 21-May-2007
Investment Opinion	C-1-7 / C-1-7
Volatility Risk	HIGH / HIGH
52-Week Range	Rs579.00-Rs840.00
Market Value (mn)	US\$2,734
Shares Outstanding (mn)	167.1 / 167.1
Average Daily Volume	226,239
ML Symbol / Exchange	DRYBF / BSE
ML Symbol / Exchange	RDY / NYS
Bloomberg / Reuters	DRRD IN / REDY.BO
ROE (2007E)	31.8%
Net Dbt to Eqty (Mar-2006A)	103.3%
Est. 5-Yr EPS / DPS Growth	15.0% / 10.0%
Free Float	73.2%



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Refer to important disclosures on page 9 to 10. Analyst Certification on page 7. Price Objective Basis/Risk on page 7.

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*iQprofile*SM Dr Reddy's Laboratories

Key Income Statement Data (Mar)	2005A	2006A	2007E	2008E	2009E
(Rs Millions)					
Sales	18,586	23,550	65,139	55,604	65,007
Gross Profit	8,451	10,346	27,581	24,387	29,266
Sell General & Admin Expense	(4,926)	(5,473)	(8,578)	(8,118)	(9,585)
Operating Profit	(318)	1,518	12,766	8,246	10,101
Net Interest & Other Income	549	495	(364)	(513)	(225)
Associates	NA	NA	NA	NA	NA
Pretax Income	108	2,013	12,402	7,733	9,876
Tax (expense) / Benefit	94	(546)	(2,744)	(1,160)	(1,580)
Net Income (Adjusted)	212	1,467	9,658	6,573	8,296
Average Fully Diluted Shares Outstanding	167	167	167	167	167

Key Cash Flow Statement Data

Net Income (Reported)	212	1,467	9,658	6,573	8,296
Depreciation & Amortization	1,317	1,617	3,791	4,201	4,468
Change in Working Capital	1,060	(2,823)	(6,769)	809	(2,288)
Deferred Taxation Charge	NA	NA	NA	NA	NA
Other Adjustments, Net	(600)	(1,003)	3,123	1,688	1,820
Cash Flow from Operations	1,989	(742)	9,803	13,270	12,296
Capital Expenditure	(2,201)	(2,851)	(3,402)	(4,200)	(3,000)
(Acquisition) / Disposal of Investments	NA	NA	NA	NA	NA
Other Cash Inflow / (Outflow)	2,831	(18)	(11,072)	3,350	601
Cash Flow from Investing	630	(2,868)	(14,473)	(850)	(2,399)
Shares Issue / (Repurchase)	30	0	452	0	0
Cost of Dividends Paid	(383)	(383)	(836)	(836)	(836)
Cash Flow from Financing	2,241	29,210	227	(13,966)	(9,252)
Free Cash Flow	(212)	(3,593)	6,401	9,070	9,296
Net Debt	(6,551)	21,373	19,387	9,622	2,512
Change in Net Debt	(2,741)	2,766	(1,987)	(9,764)	(7,110)

Key Balance Sheet Data

Property, Plant & Equipment	7,799	8,759	9,268	9,268	7,800
Other Non-Current Assets	1,936	27,893	38,067	34,717	34,115
Trade Receivables	3,821	5,104	12,847	10,967	12,824
Cash & Equivalents	9,355	9,796	5,353	3,808	4,453
Other Current Assets	5,125	11,717	16,791	14,294	16,724
Total Assets	28,035	63,270	82,325	73,053	75,916
Long-Term Debt	2,804	31,169	24,739	13,430	6,965
Other Non-Current Liabilities	209	755	740	725	711
Short-Term Debt	NA	NA	NA	NA	NA
Other Current Liabilities	5,605	10,658	16,704	13,136	15,136
Total Liabilities	8,618	42,581	42,184	27,291	22,811
Total Equity	19,418	20,689	40,142	45,762	53,105
Total Equity & Liabilities	28,035	63,270	82,325	73,053	75,916

*iQmethod*SM - Bus Performance*

Return On Capital Employed	-1.8%	4.4%	29.3%	18.6%	24.1%
Return On Equity	1.1%	7.3%	31.8%	15.3%	16.8%
Operating Margin	-1.7%	6.5%	19.9%	15.1%	15.8%
EBITDA Margin	4.7%	13.3%	25.4%	22.4%	22.4%

*iQmethod*SM - Quality of Earnings*

Cash Realization Ratio	9.4x	-0.5x	1.0x	2.0x	1.5x
Asset Replacement Ratio	1.7x	1.8x	0.9x	1.0x	0.7x
Tax Rate (Reported)	NM	27.1%	22.1%	15.0%	16.0%
Net Debt-to-Equity Ratio	-33.7%	103.3%	48.3%	21.0%	4.7%
Interest Cover	-4.1x	2.4x	8.4x	7.9x	15.2x

Key Metrics

Sales Growth (YoY)	NA	26.3%	174.6%	-15.0%	17.0%
EBITDA Growth (YoY)	NA	257.8%	428.1%	-24.8%	17.1%
Net Income Growth (YoY)	NA	593.2%	558.2%	-31.9%	26.2%
Net Profit Margin	1.1%	6.2%	14.8%	11.8%	12.8%

* For full definitions of *iQmethod*SM measures, see page 8.

Company Description

Dr Reddy's Labs is an emerging global pharmaceutical company with operations across the globe and focus on the US, Europe, Russia and India. Int'l operations account for over 60% of revenues. Reddy's recently entered into a revenue- & cost-sharing deal with ICICI Ventures for its US generics business. The company conducts research in areas of cancer, diabetes, cardiovascular, inflammation and bacterial infections.

Stock Data

Shares / ADR	1.00
Price to Book Value	2.8x
Market Cap (US\$ mn)	2,734

4Q Earnings call highlights

Outlook on Betapharm highly reassuring

DRL's maintained that the supply issues faced in 4Q by Betapharm is now behind and that the German generics business is expected to register growth in FY08E given several initiatives taken by the company in the wake of the recent industry trends.

- Betapharm's 72% drop in 4Q revenues vs 3Q (Rs750mn revenues in 4Q vs, Rs2-2.7bn in each of previous three quarters) was the result of short-term supply shortage due to disagreement on contract terms with supplier Hexal which has now been successfully negotiated.
- According to DRL, the contract with Hexal has been renegotiated to a non-exclusive basis but at the cost of higher procurement price and allows Betapharm to source from other parties. DRL believes the higher procurement prices will be more than offset by higher volumes and no supply constraints going forward.
- For FY08E, DRL expects the Betapharm business to register overall growth (vs. US\$186mn revenues in FY07E) and have entered into several contracts with insurance companies in Germany which is expected to cover 2/3rds of the German population (No. of contracts not disclosed).
- Following the re-negotiation of supply agreement with Hexal, Betapharm expects to carry out 10 product switches to India site over the next two years of which the cost synergies are expected to begin from FY08 with possibility of 3 product switches to India site in FY08E. The cost synergies from these product switches will begin to reflect from FY08E itself.
- Betapharm will likely file for 18-20 new product filings in FY08 for all major European markets through in-licensing and own products as well. Further the process of reorganizing the sales force is currently on to focus on physicians, pharmacies and insurance companies.

Bullish base business outlook for FY08E

- Indian business to continue to perform ahead of industry growth whereas Russian business likely to continue the strong double digit growth momentum; growth in CPS business expected to be moderate
- For FY08E, management have guided to a base business gross margin of 50-52% vs 47% gross margin in FY07.
- SG&A expenses are likely to remain at current levels whereas R&D expenditure is likely to be 7-8% of revenues for the company.
- DRL has significantly reduced its debt /equity in FY07 to 0.59x vs. 1.5x in FY06 and this trend is expected to continue in FY08E. In FY07E, DRL has repaid about US\$184mn in long-term and short-term debt. The company expects to bring this down further by using the available cash at its disposal. This would result in an improved financial health as well as a stronger balance sheet for the company.

4Q business highlights

DRL's stellar 4Q net profit of Rs3.25bn (80% ahead of Mle) was driven by significant one-offs - generic Zofran and Aciphex API supply. Adjusted for one-offs, we estimate 4Q core revenue growth of 64% YoY (Rs11.3bn) and sharp 10% gross margin increase (to 52% from 42% YoY) and 4Q PAT at Rs1.3-1.4bn. (adjusted for non-cash write-down of intangibles). Key points-

- Impressive 17% growth in domestic formulation revenues driven by new launches and strong growth in flagship brands, Nise & Omez. DRL is the second fastest growing company in the industry among top 10 companies.
- Strong 56% growth in formulation exports driven by 71% growth in Russia revenues (Rs700 mn) where the company has improved market ranking to 15th from 24th position in last 24 months in retail segment
- Within generics, North America contributed 84% (Rs5.6bn) while Europe (including Betapharm) contributed 16% (Rs1.09bn) to revenues. North America revenues of US\$130mn include about US\$63mn revenues from generic Zofran. Excluding Zofran, the base US generics has registered a sharp 70% growth in 4Q (excludes Allegra as well).
- Within Europe, Betapharm revenues were sharply down at Rs750Mn in 4Q vs Rs 2-2.7bn revenues in each of previous three quarters due to supply issues with Hexal and pricing impact in Germany
- North America revenues of US\$130mn in 4Q include about US\$63mn revenues from generic Zofran (under exclusivity period); ex-Zofran, the base US generics has registered a sharp 70% growth in 4Q. In FY07, DRL filed for 33 ANDAs and has 69 ANDAs pending approvals addressing US\$56bn market size. Of these there are 31 Para IVs with 18 FTFs.

4QFY07 Result Analysis

Table 1: Result Update of Dr. Reddy's Laboratories, March fiscal year-ends (Rsmn)

Year to Mar (Rs mn)	4QFY06	4QFY07	YoY %	Comments on 4QFY07 Results
Domestic sales	1,816	1,946	7%	Impressive 17% growth in domestic formulation revenues driven by new launches and strong growth in flagship brands, Nise & Omez; Growth momentum expected to continue going forward; DRL is the second fastest growing company in the industry
- Formulations	1,269	1,479	17%	
- Bulk Drugs	547	467	-15%	
Export Sales	3,929	11,381	190%	
- Formulations	811	1,264	56%	Strong 56% growth in formulations exports driven by 71% growth in Russia revenues (Rs700 mn); improved market ranking to 15th from 24th position in last 24 months in retail segment
- APIs	1,544	3,424	122%	API exports grew significantly driven by sales of key products of sertraline and rabeprazole (generic Aciphex supply to Teva which we estimate around US\$20-25mn)
- Generics (US/EU)	1,574	6,693	325%	Within generics, North America contributed 84% (Rs5.6bn) while Europe (including Betapharm) contributed 16% (Rs1.09bn) to revenues. North America revenues of US\$130mn include about US\$63mn revenues from generic Zofran; excluding Zofran, the base US generics has registered a sharp 70% growth in 4Q (excludes Allegra as well). Within Europe, Betapharm revenues were sharply down at Rs750Mn in 4Q vs Rs 2-2.7bn revenues in each of previous three quarters due to supply issues with Hexal and pricing impact in Germany
Emerging business & others	1,187	2,246	89%	
Total revenues	6,932	15,573	125%	Excluding ondasteron and acquisitions, base business grew by 53% in 4Q; Adjusted for one-off products (generic Zofran, Aciphex), we estimate DRL's core business in 4Q has registered 64% growth in revenues, sharp 10% increase in gross margin (to 52% from 42% YoY)
Cost of revenues	4,037	5,818	44%	
Gross profit	2,895	9,755	237%	Sharp gross margin expansion largely driven by high margins during ondasteron exclusivity as well as higher margins in the API and CPS business during the quarter.
Gross margin (%)	42%	63%	50%	
SG&A expenses	2,292	3,433	50%	
% of Total Revenues	33%	22%	-33%	
R&D Expenditure	678	852	26%	R&D spend includes Rs85mn revenue under R&D partnership as a benefit
% of Total Revenues	10%	5%	-44%	
Amortization expenses	162	2,221	1271%	Amortization of Rs1.77bn is largely in respect of non-cash write-down of intangibles acquired in Betapharm and CPS business in Mexico.
% of Total Revenues	2%	14%	510%	
Other operating (income)/expense	4	25		
Forex loss/ (gain)	19	(205)		
Operating income	(260)	3,429		Increase in other income reflects the impact of ADR proceeds as well as decrease in short term borrowings
OPM (%)	-4%	22%	-687%	
Equity in loss of affiliates	49	29	-41%	
Other expenses/(income) net	(12)	(113)	842%	
Income before income taxes	(297)	3,513	-1283%	Adjusted for one-off products (generic Zofran, Aciphex), we estimate core PAT for 4Q at Rs1.3-1.4bn (adjusted for non-cash write-down of intangibles).
Income tax (benefit)/expense	(61)	260	-526%	
Minority interest	1	1	0%	
Net income - reported	(237)	3,252	-1472%	Net income about 80% ahead of Mle

Source: Company data, Merrill Lynch Research

Profit Model

Table 2: Dr. Reddy's Laboratories-Profit Model, March Fiscal Yearends, 2005-2009E

Year to Mar (Rs mn)	2005	2006	2007E	2008E	2009E
Domestic bulk	1,972	2,296	2,075	2,117	2,159
Domestic formulations	4,360	5,525	6,415	7,289	8,304
Domestic sales	6,332	7,821	8,490	9,406	10,463
Export bulk	4,972	5,942	9,752	11,009	12,451
Export formulations	3,463	4,400	5,904	7,085	8,502
International Generics	3,577	4,056	33,224	19,195	23,376
Export sales	12,012	14,398	48,880	37,289	44,329
Emerging business/custom synthesis	839	2,018	7,424	8,538	9,818
Others	30	368	332	365	401
Gross sales	19,472	24,605	65,126	55,597	65,011
Less : Excise duty	948	1,216	897	993	1,105
Net sales	18,524	23,389	64,229	54,604	63,906
Other operational income	62	161	910	1,001	1,101
Net operating revenue	18,586	23,550	65,139	55,604	65,007
Cost of goods sold	7,197	9,709	31,125	24,462	28,310
Personnel	2,938	3,495	6,433	6,755	7,430
SG&A	4,926	5,473	8,578	8,118	9,585
R & D Expenditure	2,526	1,737	2,446	3,822	5,112
Total expenditure	17,587	20,415	48,582	43,157	50,438
EBITDA	999	3,135	16,557	12,447	14,569
Interest	108	644	1,526	1,050	663
Non-operating income	657	1,139	1,162	537	438
Depreciation/amortization	1,317	1,617	3,791	4,201	4,468
Pretax profits before write-offs	231	2,013	12,402	7,733	9,876
Tax (including deferred tax credit)	(94)	546	2,744	1,160	1,580
Minority interest	10	0	0	0	0
Net profits-reported	212	1,467	9,658	6,573	8,296
Adjusted Net profits	212	1,467	9,658	6,573	8,296

Key parameters

Dividends	382.6	383.5	836.0	836.0	836.0
DPS (Rs)	4.0	5.0	5.0	5.0	5.0
Fully-diluted shares (mn)	167.1	167.1	167.1	167.1	167.1
EPS (Rs)-fully diluted	1.3	8.8	57.8	39.3	49.6
Cash EPS yearend (Rs)	9.1	18.5	80.5	64.5	76.4
CEPS (Rs)-fully diluted	9.1	18.5	80.5	64.5	76.4
Book value per share yearend (Rs)	116.2	123.8	240.2	273.9	317.8
Book value per share (Rs) wtd	116.2	123.8	240.2	273.9	317.8

Margins (%)

Operating Profit Margin	5.4	13.3	25.4	22.4	22.4
Gross Profit Margin	61.3	58.8	52.2	56.0	56.5
Net Profit Margin	1.1	6.2	14.8	11.8	12.8

Growth (% YoY)

Domestic revenues	-7.5	23.5	8.6	10.8	11.2
Export revenues	-4.9	19.9	239.5	-23.7	18.9
Gross revenues	-3.6	26.4	164.7	-14.6	16.9
Operating Profit	-66.8	213.8	428.1	-24.8	17.1
Net Profit	-91.6	593.2	558.2	-31.9	26.2
EPS	-91.6	593.2	558.2	-31.9	26.2

Source: Company data, Merrill Lynch Research

Price Objective Basis & Risk

We revise our PO downwards to Rs850/sh based on revised estimates of FY09E. We value DRL on a comparative P/E valuation of 17x on FY09E EPS (which is in line with the company's historical average P/E).

Risks to PO: a) Risk of further regulatory and pricing pressures in Germany, b) challenge to gain size in US generic space, c) higher-than-expected US generic pricing pressure, d) acquisition and e) domestic market challenges.

Analyst Certification

I, Visalakshi Chandramouli, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

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21 May 2007

***iQmethod*SM Measures Definitions**

Business Performance	Numerator	Denominator
Return On Capital Employed	$\text{NOPAT} = (\text{EBIT} + \text{Interest Income}) * (1 - \text{Tax Rate}) + \text{Goodwill Amortization}$	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill
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	$\text{EV} = \text{Current Share Price} * \text{Current Shares} + \text{Minority Equity} + \text{Net Debt} + \text{Sales Other LT Liabilities}$	
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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Important Disclosures

DRYBF Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of April 30, 2007 or such later date as indicated.

RDY Price Chart



B : Buy, N : Neutral, S : Sell, PO : Price objective, NA : No longer valid

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark Grey shading indicates the security is restricted with the opinion suspended. Light Grey shading indicates the security is under review with the opinion withdrawn. Chart current as of April 30, 2007 or such later date as indicated.

Investment Rating Distribution: Health Care Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	97	46.86%	Buy	25	27.78%
Neutral	100	48.31%	Neutral	32	34.41%
Sell	10	4.83%	Sell	3	33.33%

Investment Rating Distribution: Global Group (as of 31 Mar 2007)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1562	45.16%	Buy	415	30.09%
Neutral	1615	46.69%	Neutral	446	30.65%
Sell	282	8.15%	Sell	49	19.76%

* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months.

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