MOTILAL OSWAL

Dr. Reddy's Laboratories

STOCK INFO.	BLOOMBERG
BSE Sensex: 19,243	DRRD IN
	REUTERS CODE
S&P CNX: 5,702	REDY.BO

Equity Shares (m)	167.9
52-Week Range (Rs)	840/580
1,6,12 Rel. Perf. (%)	-18/-50/-66
M.Cap. (Rs b)	102.8
M.Cap. (US$ b)	2.6

26 October 2007

Buy

Previous Recommendation: Buy

Rs612

YEAR END	NET SALES (RS M)	PAT (RS M)	EPS (RS)	EPS GROWTH (%)	P/E (X)	P/BV (X)	ROE (%)	ROCE (%)	EV/ SALES	EV/ EBITDA
03/07A	65,095	9,323	55.5	521.1	11.0	2.5	22.4	14.3	1.7	7.5
03/08E*	49,168	6,542	39.0	-29.8	15.7	2.2	14.1	10.3	2.2	13.2
03/09E*	55,529	7,023	41.8	7.4	14.6	2.0	13.6	10.4	1.9	10.6

**Excludes one-time upsides from authorized generics and FTF opportunities*

Dr. Reddy's Labs 2QFY08 results were below expectations. Key highlights:

- Net sales declined by 37% to Rs12.7b (v/s est. of Rs12.4b) while reported PAT was down 4.6% to Rs2.67b (v/s est. of Rs1.47b). On a like-to-like basis, top-line growth was about 3.6% impacted by currency appreciation and slow-down in the domestic formulation and CPS portfolio. It has booked a one-time tax write-back of Rs1.5b (related to Betapharm) and forex gains of Rs256m which has boosted PAT.
- However EBITDA margins at 11.5% declined by 950bp due to significant increase in SG&A expense at 33.4% of sales (vs est. of 29% of sales). Management has indicated that SG&A expenses will revert back to normalcy in 2HFY08 and the higher spend in 2Q included one-time elements (details not disclosed).
- **German operations being restructured -** DRL is in the process of shifting manufacturing of products back to its Indian facilities (which could result in cost savings of about 30%). It expects to shift about 60% of the production to India by Mar-2008 implying that the cost benefits will be visible in FY09E. In the interim the German business will continue to be under pressure due to supply constraints from its existing supplier.

While we have downgraded our EBITDA margin estimates for FY08E by 100bp (to 16.5%) to take into account the slow-down in revenues and higher SG&A and R&D costs, our earnings estimates have been upgraded by 3% to take into account the higher other income recorded by the company in 1HFY08. DRL is currently valued at 15.7x FY08E and 14.6x FY09E consolidated earnings. While FY08 performance will be impacted due to significant higher base effect, we believe that current valuations are not discounting the expected improvement in core business, and growth traction in semi-regulated markets. We maintain **Buy.**

QUARTERLY PERFORMANCE-US GAAP (Rs Million)

Y/E MARCH	FY07				FY08				FY07	FY08E
	1Q	2Q	3Q	4Q	1Q	2Q	3QE	4QE		
Gross Sales	**14,049**	**20,039**	**15,434**	**15,573**	**12,018**	**12,669**	**11,995**	**12,486**	**65,095**	**49,168**
YoY Change (%)	*151.3*	*247.1*	*161.7*	*124.7*	*-14.5*	*-36.8*	*-22.3*	*-19.8*	*168.2*	*-24.5*
EBITDA	**2,210**	**4,220**	**2,464**	**5,470**	**2,132**	**1,461**	**2,159**	**2,361**	**14,361**	**8,113**
Margins (%)	*15.7*	*21.1*	*16.0*	*35.1*	*17.7*	*11.5*	*18.0*	*18.9*	*22.1*	*16.5*
Depreciation & Amortization	388	402	330	2,221	351	410	350	389	3,341	1,500
Interest	0	0	0	0	0	0	0	0	0	0
Other Income	-216	-287	-281	264	231	372	83	135	-520	821
Profit before Tax	**1,606**	**3,531**	**1,853**	**3,513**	**2,012**	**1,423**	**1,892**	**2,107**	**10,500**	**7,434**
Tax	208	737	-27	260	181	-1,248	208	251	1,177	-608
Rate (%)	*13.0*	*20.9*	*-1.5*	*7.4*	*9.0*	*-87.7*	*11.0*	*11.9*	*11.2*	*-8.2*
Reported PAT	**1,398**	**2,794**	**1,880**	**3,253**	**1,831**	**2,671**	**1,684**	**1,856**	**9,323**	**8,042**
Minority Interest	0	-4	0	-1	3	1	0	-4	-4	0
EO (Exp)/Inc	42	0	0	0	0	0	0	0	42	0
Adjusted PAT	**1,356**	**2,798**	**1,880**	**3,254**	**1,828**	**2,670**	**1,684**	**1,860**	**9,285**	**8,042**
YoY Change (%)	*255.0*	*215.4*	*407.6*	*-*	*34.8*	*-4.6*	*-10.4*	*-42.8*	*576.6*	*-13.4*
Margins (%)	*9.7*	*14.0*	*12.2*	*20.9*	*15.2*	*21.1*	*14.0*	*14.9*	*14.3*	*16.4*

E: MOSt Estimates

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Currency appreciation and slow-down in Germany & Mexico impact core performance

DRL's net sales declined by 37% to Rs12.7b (vs est. of Rs12.4b) while reported PAT was down 4.6% to Rs2.67b (vs est. of Rs1.47b). As expected, sales declined due to absence of authorized generic revenues which had contributed Rs7.8b in sales for 2QFY07. On a like-to-like basis, top-line growth was about 3.6% impacted by currency appreciation and slow-down in the domestic formulation and CPS portfolio.

DRL's CPS business declined by 30% to Rs1.1b due to supply constraints at its Mexico facility. While the company has commissioned a new facility to address these supply issues, it indicated that the short-term performance of the division is likely to be impacted adversely due to lower demand for Naproxen.

TREND IN PRODUCT AND REGIONAL MIX (RS M)

	2QFY08	2QFY07**	% CH.	1QFY08	% CH.
Sales Break Up - US GAAP					
APIs	**3,240**	**2,906**	**11.5**	**2,617**	**23.8**
India	703	502	40.0	535	31.4
International	2,537	2,404	5.5	2,082	21.9
Branded Formulations	**3,815**	**3,056**	**24.8**	**4,051**	**-5.8**
India	2,054	1,743	17.8	2,022	1.6
International	1,761	1,313	34.1	2,029	-13.2
Generics	**4,392**	**12,113**	**-63.7**	**4,247**	**3.4**
Cust. Chem. &Others	**1,222**	**1,737**	**-29.6**	**1,103**	**10.8**
Total Revenues	**12,669**	**20,039**	**-36.8**	**12,018**	**5.4**

*** - Includes one-time impact of Rs7.8b of authorized generic revenues*

Source: Company/Motilal Oswal Securities

Overall gross margins (GPM) were at 51.3%, improvement of 1,000bp, due to absence of authorized generic revenues and margin improvement in API business linked to change in product-mix. This is despite a strong currency appreciation YoY. However EBITDA margins at 11.5% declined by 950bp due to significant increase in SG&A expense at 33.4% of sales (vs est. of 29% of sales). Management has indicated that SG&A expenses will revert back to normalcy in 2HFY08 and the higher spend in 2Q included one-time elements (details not disclosed). The company has recorded a one-time tax write-back of Rs1.5b (related to Betapharm) and forex gains of Rs256m which has boosted PAT.

Competition for generic Allegra unlikely to intensify

Although, the 30-month stay periods on Allegra in the US for some of the generic players have expired, they are yet to launch their versions. Entry of some of the potential generic players has been delayed and hence DRL is likely to enjoy higher margins on this product for some more time. This product contributed about Rs586m to DRL's 2QFY08 sales.

Strong generic pipeline

DRL has significantly strengthened its product pipeline for regulated markets, with 9 ANDA (of which 3 are Para IV filings) filed during 1HFY08. It has around 69 ANDAs pending approval with the US FDA with a pragmatic mix of normal products and Para-IV filings. The company has a pipeline of 21 FTFs. It also has one of the strongest API pipelines of over 100 DMFs, some of which can offer large one-time upsides if linked with exclusivity based supplies. Examples of these include supply of Sertraline and Rabeprazole to Teva in FY07.

Betapharm restructuring benefits to accrue gradually

DRL plans to make Betapharm more profitable by shifting manufacturing to its Indian facilities. It has recently re-negotiated its supply agreement with Solutus to make it non-exclusive as a first step towards the shift in manufacturing. DRL is targeting shifting about 7-8 products to India over the next 12 months. We believe that it will be a more gradual process due to the changes required in product filings. Our estimates do not factor-in any significant margin expansion due to this. While the German business is likely to remain under pressure in the short-term, DRL management has indicated positive PAT growth for the German business in FY09 over FY08.

German GKV-WSG reforms - Raises uncertainty on drug pricing

The act for strengthening competition in the public health insurance (GKV-WSG) has come into effect in Germany from 01-Apr-07. Amongst other changes, the new rules will allow for possibilities for direct contractual price agreements between health insurance organizations, individual service providers and suppliers. This will again lead to comprehensive structural changes of the German health care system and the markets associated.

While the actual impact of this change will be visible over a period of time, we do not rule out further price cuts as the changes aim at direct price negotiations between the insurance companies and the pharmaceutical manufacturers through competitive tendering.

Germany's largest health insurance company - AOK - has already made a beginning in this direction by floating a tender inviting competitive bids from pharmaceutical companies for a set of 10-15 drugs. Other insurance companies may adopt a similar strategy over a period of time. As per the new changes, the insurance companies will invite bids for a set of drugs, which will be supplied to the wholesalers/retailers at the prices decided in the tendering process.

We believe that if the entire healthcare system in Germany shifts to this new sourcing arrangement, then the nature of the market will undergo a change from being a branded generic market to a pure generic market (like the US) in the long-term. This implies that while drug prices may become more competitive, cost savings in branding & promotion as well as volume expansion for generics (due to lower prices) will partly compensate for the margin decline in the long-term.

Also, given the fact that the German generic market witnessed two price cuts (in quick succession) in 2006, the industry is likely to offer stiff resistance to any further significant price cuts. As of now, there are no indications regarding the extent of price cuts and the proportion of the German market, which will be covered by the new system.

Domestic business to slow-down in 2HFY08 post 19% growth in 1HFY08

DRL has recorded ~19% growth in domestic portfolio in 1HFY08 led by aggressive new launches and increasing penetration for existing products. Management has guided a relatively soft 2HFY08 due to the higher growth recorded in 1HFY08.

Retain Buy

Over the last 2 years, DRL has taken significant steps to revitalize its business. These have mainly been directed at reducing risks and achieving scale. The first obvious step by DRL was to reduce costs and the risks attendant with its generic business and NCE research. This was achieved by resorting to external funding from financial investors and is likely to reduce DRL's SG&A expenses from as high as 35% of sales in FY05 to 28.5% by FY08E. R&D expenses are likely to reduce from 13% of sales to around 6% in the same period.

DRL's generic strategy, in the past, was skewed towards patent challenges and the company suffered substantial setbacks (omeprazole & amlodipine), which prevented the company from gaining critical mass in the global generic markets. Hence, the company has resorted to inorganic growth to gain scale resulting in the US$580m acquisition of Betapharm to gain a strong foothold in the German market.

While we have downgraded our EBITDA margin estimates for FY08E by 100bp (to 16.5%) to take into account the slow-down in revenues and higher SG&A and R&D costs, our earnings estimates have been upgraded by 3% to take into account the higher other income recorded by the company in 1HFY08. DRL is currently valued at 15.7x FY08E and 14.6x FY09E consolidated earnings. While FY08 performance will be impacted due to significant higher base effect, we believe that current valuations are not discounting the expected improvement in core business, and growth traction in semi-regulated markets. We maintain **Buy** with price target of Rs800.

Dr. Reddy's Laboratories: an investment profile

Company description

Dr Reddy's is among the largest domestic pharma companies in India with a strong focus on the global generics opportunity and basic drug discovery. The company has, in the past, gone through a lean patch on account of an adverse shift in product mix and a rapidly rising cost structure – fallouts of the company's strategy for the US markets. Subsequently, it has been taking steps to balance short-term profitability with longer-term growth goals.

Key investment arguments

- Efforts to step up the number of non-Para-IV filings and focus on partnerships in overseas markets would help build critical scale over two years.
- Transfer of manufacturing to India to augur well for German operations in the long-term.

Key investment risks

- Lags behind sector leader Ranbaxy in terms of global footprint and underlying product basket.
- German operations will continue to be a drag on the business in the short-term.

Recent developments

- Nil

Valuation and view

- Valuations at 15.7x FY08E and 14.6x FY09E earnings (excl one-time upsides) are not demanding.
- Increased traction based on improvement in core business coupled with large one-time opportunities; Maintain **Buy** with target price of Rs800.

Sector view

- Regulated markets would remain the key sales and profit drivers in the medium term. Europe is expected to emerge as the next growth driver.
- We are Overweight on companies that are towards the end of the investment phase.

COMPARATIVE VALUATIONS

		DRL	CIPLA	RANBAXY
P/E (x)	FY08E	15.7	23.4	21.9
	FY09E	14.6	19.6	21.6
P/BV (x)	FY08E	2.2	3.9	16.8
	FY09E	2.0	3.3	4.7
EV/Sales (x)	FY08E	2.2	3.6	2.3
	FY09E	1.9	3.1	2.4
EV/EBITDA (x)	FY08E	13.2	18.0	14.8
	FY09E	10.6	15.4	14.0

SHAREHOLDING PATTERN (%)

	SEP-07	JUN-07	SEP-06
Promoter	25.2	25.2	27.5
Domestic Inst	17.1	16.0	11.3
Foreign	43.6	43.7	48.3
Others	14.1	15.1	12.9

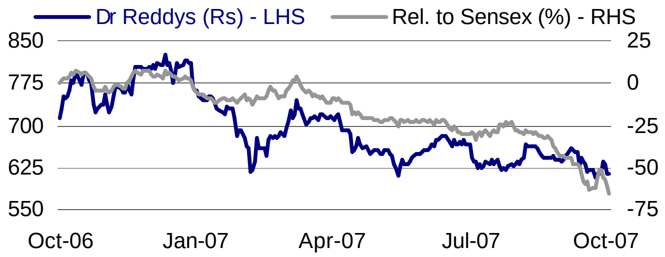
EPS: MOST FORECAST VS CONSENSUS (RS)

	MOST FORECAST	CONSENSUS FORECAST	VARIATION (%)
FY08	39.0	34.7	12.1
FY09	41.8	40.9	2.2

TARGET PRICE AND RECOMMENDATION

CURRENT PRICE (RS)	TARGET PRICE (RS)	UPSIDE (%)	RECO.
612	800	30.7	Buy

STOCK PERFORMANCE (1 YEAR)



INCOME STATEMENT					(Rs Million)
Y/E MARCH	2005	2006	2007	2008E	2009E
Net Sales	**19,519**	**24,267**	**65,095**	**49,168**	**55,529**
Change (%)	*-2.9*	*24.3*	*168.2*	*-24.5*	*12.9*
Total Expenditure	18,970	22,667	50,666	41,055	45,784
EBITDA	**550**	**1,600**	**14,429**	**8,113**	**9,745**
Change (%)	*-74.4*	*191.1*	*801.7*	*-43.8*	*20.1*
Margin (%)	*2.8*	*6.6*	*22.2*	*16.5*	*17.6*
Amortization	350	420	3,341	1,500	1,240
EBIT	**200**	**1,180**	**11,088**	**6,613**	**8,506**
Other Income - Rec. (incl-	-93	319	-587	821	-434
PBT & EO Expense	**107**	**1,499**	**10,500**	**7,434**	**8,072**
Change (%)	*-95.8*	*1,300.8*	*600.4*	*-29.2*	*8.6*
Extra Ordinary Expense	0	-388	0	0	0
PBT after EO Expense	**107**	**1,887**	**10,500**	**7,434**	**8,072**
Tax	-94	258	1,177	892	1,049
Tax Rate (%)	*-88.1*	*13.7*	*11.2*	*12.0*	*13.0*
Minority Interest	-10	0	-3	0	0
Reported PAT	**211**	**1,629**	**9,327**	**6,542**	**7,023**
Adjusted Net Profit	**201**	**1,371**	**9,323**	**6,542**	**7,023**
Change (%)	*-91.9*	*581.1*	*579.9*	*-29.8*	*7.4*
Margin (%)	*1.0*	*5.7*	*14.3*	*13.3*	*12.6*

BALANCE SHEET					(Rs Million)
Y/E MARCH	2005	2006	2007	2008E	2009E
Equity Share Capital *	383	383	840	840	840
Reserves	20,571	21,888	40,739	45,665	50,954
Net Worth	**20,953**	**22,272**	**41,578**	**46,505**	**51,793**
Loans	2,827	30,995	24,764	18,464	18,464
Deferred Liabilities/Tax	373	6,229	7,085	7,085	7,085
Capital Employed	**24,154**	**59,496**	**73,427**	**72,054**	**77,343**
Net Fixed Assets	**7,160**	**9,311**	**12,703**	**16,903**	**17,953**
Investments	1,487	1,238	1,331	1,331	1,331
Goodwill/Intangible Assets	2,588	33,669	34,429	34,429	34,429
Curr. Assets	**17,816**	**24,377**	**36,898**	**29,716**	**35,291**
Inventory	3,500	6,895	7,546	5,900	6,664
Account Receivables	3,609	5,054	7,669	6,146	6,941
Cash and Bank Balance	9,288	3,713	17,981	12,753	16,133
Others	1,419	8,715	3,702	4,917	5,553
Curr. Liability & Prov.	**4,898**	**9,098**	**11,934**	**10,325**	**11,661**
Account Payables	1,555	3,791	4,756	5,408	6,108
Other Current Liabilities	3,343	5,307	7,178	4,917	5,553
Net Current Assets	**12,918**	**15,278**	**24,964**	**19,391**	**23,629**
Appl. of Funds	**24,154**	**59,496**	**73,427**	**72,054**	**77,343**

*E: MOSt Estimates; * Equity has increased due to 1:1 bonus & ADR issue.*

RATIOS					
Y/E MARCH	2005	2006	2007	2008E	2009E
Basic (Rs)					
EPS	**1.3**	**8.9**	**55.5**	**39.0**	**41.8**
Cash EPS	3.6	11.7	75.4	47.9	49.2
BV/Share	136.9	145.2	247.6	277.0	308.5
DPS	2.5	2.5	7.2	4.8	5.2
Payout (%)	216.7	31.9	29.7	28.2	28.2
Valuation (x)					
P/E		68.5	11.0	15.7	14.6
Cash P/E		52.4	8.1	12.8	12.4
P/BV		4.2	2.5	2.2	2.0
EV/Sales		5.3	1.7	2.2	1.9
EV/EBITDA		80.5	7.5	13.2	10.6
Dividend Yield (%)		0.4	1.2	0.8	0.8
Return Ratios (%)					
RoE	1.0	6.2	22.4	14.1	13.6
RoCE	0.4	2.5	14.3	10.3	10.4
Working Capital Ratios					
Asset Turnover (x)	0.8	0.4	0.9	0.7	0.7
Debtor (Days)	67	76	43	46	46
Inventory (Days)	65	104	42	44	44
Working Capital (Days)	68	174	39	49	49
Leverage Ratio					
Current Ratio (x)	3.6	2.7	3.1	2.9	3.0
Debt/Equity (x)	0.1	1.4	0.6	0.4	0.4

**Adjusted for bonus issue*

CASH FLOW STATEMENT					(Rs Million)
Y/E MARCH	2005	2006	2007	2008E	2009E
Oper. Profit/(Loss) before Ta	550	1,600	14,429	8,113	9,745
Interest/Dividends Recd.	-93	319	-587	821	-434
Direct Taxes Paid	94	-258	-1,177	-892	-1,049
(Inc)/Dec in WC	902	-7,935	4,583	345	-859
CF from Operations	**1,454**	**-6,274**	**17,247**	**8,387**	**7,404**
EO Expense	0	-388	0	0	0
CF from Operating incl	**1,454**	**-5,886**	**17,247**	**8,387**	**7,404**
(inc)/dec in FA	-1,012	-33,652	-7,493	-5,700	-2,290
(Pur)/Sale of Investments	2,892	250	-94	0	0
CF from Investments	**1,880**	**-33,402**	**-7,587**	**-5,700**	**-2,290**
Issue of Shares	139	127	12,749	226	243
(Inc)/Dec in Debt	1,865	34,024	-6,231	-6,300	0
Other Items	10	0	855	0	0
Dividend Paid	-436	-437	-2,765	-1,842	-1,977
CF from Fin. Activity	**1,578**	**33,714**	**4,608**	**-7,915**	**-1,734**
Inc/Dec of Cash	**4,912**	**-5,575**	**14,268**	**-5,228**	**3,380**
Add: Beginning Balance	4,376	9,288	3,713	17,981	12,753
Closing Balance	**9,288**	**3,713**	**17,981**	**12,753**	**16,133**

Note: Reported cashflow differs due to acquisition

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Disclosure of Interest Statement	Dr. Reddy's Laboratories
1. Analyst ownership of the stock	No
2. Group/Directors ownership of the stock	No
3. Broking relationship with company covered	No
4. Investment Banking relationship with company covered	No