21 May 2007
BSE Sensex: 14303

Dr. Reddy's Laboratories

Rs666
OUTPERFORMER

RESULT NOTE

Mkt Cap: Rs102bn; US$2.1bn

Analyst: Nitin Agarwal, (91-22-6638 3395; nitinagarwal@sski.co.in)

Result: Q4FY07

Comment: Turbo charged quarter

Last report: 28 Mar 2007 (Price Rs681; Recommendation: Outperformer)

Key financials

Year to 31 Mar (Rs m)	Net Sales	% change yoy	Net profit	EPS (Rs)	% change yoy	PER(x)
FY2006	24,267	24.6	1,362.0	8.9	544.1	74.9
FY2007	65,095	168.2	9,328.0	58.1	553.7	11.5
FY2008E	52,829	(18.8)	6,139.0	36.6	(37.0)	18.2
FY2009E	61,760	16.9	6,972.0	41.6	13.6	16.0

Dr. Reddy's Labs (DRL's) Q4'FY07 headline results are significantly ahead of estimates largely driven by contribution from high margin one-offs like higher Ondansetron sales and unanticipated Rabeparazole API sales to Teva along with strong performance in all core business segments (except Betapharm). Despite Rs1.77bn write-off in Betapharm, profits at Rs3.25bn are far ahead of market estimates. Q4FY07 sales in Betapharm (Germany) have been impacted due to supply disruptions which have now been sorted out with the finalization of a new non-exclusive contract with Hexal. DRL has highlighted that while near term profitability in German business might be under pressure due to switch to this non-exclusive contract, the flexibility to seek other options and accelerated outsourcing of product manufacturing to India by FY08end will significantly enhance DRL's cost competitiveness in medium term. Management guidance on 50-52% gross margins, incremental growth in APIs on a much higher base, continued growth in branded formulations and improved performance in Germany is very positive. We believe that street is underestimating strength of DRL's core business and DRL's capabilities to profitability reorient its business model to the changing market dynamics in Germany. Additionally DRL has potential FTF status on ~$10bn worth of drugs which will continue to drive upsides. We reiterate that with its well balanced generics and discovery portfolio, DRL is one of our top picks in the space. We maintain our earning estimates and reiterate Outperformer with a price target of Rs835 (22.7xFY08E and 20x FY09E).

KEY RESULT HIGHLIGHTS

❑ Revenue – All round growth driven by Ondansetron and Aciphex API sales

DRL's revenue has grown 224% yoy to Rs. 15.6bn significantly ahead of expectations. Yoy growth rates are strictly not comparable due to the consolidation of acquisitions

- Key growth contributors include 122% growth in API exports, 88% growth in CPS and 32% growth in branded formulations. Additionally the company has recorded Rs2700m of Ondansetron sales which is ahead of estimates and ~1200m of Simva AG sales. DRL continues to sell one AG dosage form which has resulted in ~Rs1.3bn of AG sales.

Segmental Revenue (Rs mn)

(Rs m)	Q4FY06	Q1FY07	Q2FY07	Q3FY07	Q4FY07
API	2,090	2,300	2,906	2,729	3,891
Branded Form	2,080	3,337	3,056	3,183	2,743
Generics - US / EU	869	1,393	1,751	1,411	1,936
Betapharma	705	1,998	2,554	2,664	788
Authorized Generics		3,346	7,808	3,385	1,261
Ondansetron				223	2,700
Custom Pharmaceutical	1,037	1,418	1,668	1,568	1,945
CC and Biotech	164	198	69	204	194
Others		58	227	67	107
Total Revenues	6,945	14,048	20,039	15,434	15,565

- API exports growth has been driven by the unanticipated Rabeparazole supplies to Teva in preparation for an early Aciphex launch. While the management has not disclosed details, we expected Rabeparazole would have contributed ~Rs1000-1200mn in sales during the quarter at very attractive gross margins. This is yet another example the periodic lucrative upsides offered by DRL's business model.
- Overall, API exports have grown 62% yoy for FY07. While a large part of this growth is on account of Sertraline and Rabeparazole, DRL's investments in building up a strong API business are paying off. DRL has built up strong relationships with large generics and regional players and is well set to capitalize on these going forward. Management guidance of incremental growth over the huge FY07 base is indicative of its potential
- 32% growth in branded formulations has been driven by 56% growth in exports and 17% growth in domestic sales. DRL has been amongst the fastest growing companies in Russia and has now become the 14 largest company (up from 25th). Further the sales are growing rapidly in the newer markets of Romania, Venezuela, South Africa etc. Even in the domestic market, DRL has been amongst the fastest growing top 10 companies. We expect branded formulations to remain a key growth segment for DRL.
- US Generics business has continued to grow strongly on the back of steady Fexofenadine sales. DRL has captured 24% of an intensely competitive Simvastatin generics market which is very positive

❑ Germany- May seem a challenge now but will drive value creation

- The key disappointment has been lower than expected growth in Germany with only Rs788m sales for the quarter. Betapharm had an exclusive supply arrangement with Hexal. During the quarter there were disruptions in supply due to problems with Hexal which led to significant loss of sales.
- DRL is working on multiple measures to regain the business momentum in Germany. DRL has since renegotiated a non-exclusive supply arrangement with Hexal and is working on accelerating the outsourcing of its top 10 products to India by end FY08. The first product is expected to be outsourced over the next few months. While the non-exclusive arrangement will lead to lower gross margins in the near term, we expect outsourcing to India to significantly enhance Betapharm's competitiveness going forward. Further DRL gets the flexibility to continuously seek lower cost manufacturing options for different products.
- Simultaneously the company is working on aggressively building its pipeline in Germany. It will be filing 18-20 new products in FY08 and will be further supporting it with alliances.
- Also, in line with changing dynamics in the business DRL has also tied up with insurance companies to cover 2/3rds of the population. The company has indicated that it is reorganizing its sales force and is well prepared to adopt the cost structure to the changes in the business environment
- Overall, the management has indicated its confidence is meeting and surpassing the current year financial performance going forward. We believe that the market is underestimating DRL's capabilities to successfully manage the transition in the German market and believe that Betapharm performance is likely to exceed market expectations.

❑ Operating Profits: Way ahead of estimates despite Rs1770m write down of intangibles

- Gross margins at 63.6% are significantly superior to estimates on account of very strong contribution from high profit opportunities like Ondansetron exclusivity and Rabeparazole API supply to Teva as well as very strong profitability across most core businesses. For FY07, branded formulations gross margins at 70% are the highest ever along with 29% margins for CPS business and 39% margins for APIs. This clearly reflects the underlying profitability of the core business even after accounting for one-off opportunities.
- During the quarter, DRL has written down Rs1770 worth of intangibles (goodwill) in the Betapharm business owing to the decline in market profitability. The company has indicated that it does not foresee any other good will write down going forward.
- R&D charges at Rs852m are 28% higher yoy. DRL has used up the entire $22.5m available as part of its I-Ven deal to fund ANDAs so going forward we expect R&D costs to grow at a higher rate as they would not be compensated by I-Ven funding.
- Another key positive is that SG&A expenses growth is in line. It alleviates concerns around fast expansion of DRL's fixed cost base and will enable DRL to obtain higher operating leverage going forward.
- Post the Rs1770m write down, operating profits are Rs3675m (23.6% margins) against expectations of Rs2910m

❑ Net profit of Rs 3.25bn

- Net profit at Rs3.25bn is ahead of our expectations of Rs1.7bn profits. Net profits are aided by lower tax rate on account of supplies of key products like Ondansetron from tax free units.

❑ Other highlights of the Analyst Call

- Management has indicated that the Balaglitazone phase III trials will start over the next few months upon receiving trial protocol approval from the regulatory authorities. The company has also indicated that it will be filing for orphan drug status for its oncology compound DRF1042. If approved, this will allow DRL and its partner to significantly cut short the approval time. Additionally, as part of its R&D tie-up with Argenta, DRL has identified a lead COPD compound which will go in clinics shortly.
- Management has expressed confidence in DRL's strong product development capabilities to drive future growth. The company is banking on oncology and biogenerics to drive its transition from generics to a discovery led company over the next few years. Biologics is key area of focus with multiple products in different stages of development. The company is targeting the non-regulated markets in the initial stages. We believe this focus on biologicals is a big positive for DRL
- The company will be stepping up generics R&D to develop increased number of products for US and Europe. We have been very bullish on DRL's future product development engine as a key driver of its growth and management's confidence and statements underscore our view
- The company continues to build up its ANDA and DMF pipeline in US. During the year the company filed 33 ANDAs and 43 DMFs. The company is seeking to step up the filing rate through partnerships.
- Company has 69 ANDAs pending in US with 18 potential FTFs. The FTFs represent ~$10bn worth of market opportunity.

❑ Valuations and view

DRL has had a super quarter and full year in terms of revenue as well as profitability growth. We believe that while such a performance may not get repeated in FY08 due to the absence of one-time opportunities like Simva AG, it clearly highlights the potential of DRL's business model. We continue to maintain our positive view on DRL's outlook and believe that DRL is amongst the strongest Indian plays with a healthy balance between generics and discovery. While the challenges in German market have put pressure on Betapharm performance and may continue to do so in the near term, we remain very confident of DRL management's ability to successfully and profitably reorient the business to the changed marked dynamics. On the back of its large Para IV pipeline, growing discovery focus and a strong business development team, we believe DRL will continue to have the best news flow in the industry. Additionally DRL has potential FTF status on ~$10bn worth of drugs which will continue to drive upsides. We reiterate that with its well balanced generics and discovery portfolio, DRL is one of our top picks in the space. We maintain our earning estimates and reiterate Outperformer with a price target of Rs835 (22.7xFY08E and 20x FY09E).

Quarterly results

	Q3FY06	Q4FY06	FY06	Q1FY07	Q2FY07	Q3FY07	FY07E	FY08E	FY09E
Net Sales	**6,974**	**24,267**	**14,049**	**20,039**	**15,434**	**15,573**	**65,095**	**52,829**	**61,760**
Operating Expenses	6,993	22,600	11,769	15,821	12,970	11,898	50,666	44,127	51,819
Cost of Sales	4,036	12,417	7,960	11,752	8,690	5,818	34,220	26,387	32,437
COGS (%)	57.9	51.2	56.7	58.6	56.3	37.4	52.6	49.9	52.5
Other Expenses	2,279	8,030	3,276	3,667	3,604	3,458	13,984	14,596	15,902
R&D	678	2,153	533	402	676	852	2,463	3,144	3,480
Intangible Write-down						1,770	1,770		
EBITDA	**(19)**	**1,666**	**2,280**	**4,218**	**2,464**	**3,675**	**12,659**	**8,703**	**9,941**
EBITDA %	(0.3)	6.9	16.2	21.0	16.0	23.6	19.4	16.5	16.1
Other Income	(116)	252	(286)	(285)	(281)	289	(587)	(394)	(394)
Amortization	162	420	388	402	330	451	1,571	1,359	1,350
PBT	**(297)**	**1,498**	**1,606**	**3,531**	**1,853**	**3,513**	**10,501**	**6,950**	**8,197**
Extraordinary	-	388					-	-	-
Provision for Taxation	(62)	258	208	737	(27)	260	1,177	815	1,230
Minority Interest	1	-		(4)		(1)	(4)	(4)	(5)
PAT	**(236)**	**1,628**	**1,398**	**2,798**	**1,880**	**3,252**	**9,328**	**6,139**	**6,972**
Adjusted PAT	(236)	1,362	1,398	2,798	1,880	3,252	9,328	6,139	6,972
yoy growth (%)									
Net Sales						123.3	168.2	(18.8)	16.9
EBITDA							659.7	(31.3)	14.2
Net Profit							472.8	(34.2)	13.6
Adjusted Profit							584.9	(34.2)	13.6

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Disclaimer

Explanation of Ratings:

1. Outperformer: More than 10% to Index
2. Neutral: Within 0-10% to Index
3. Underperformer: Less than 10% to Index

Disclosure of interest:

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