

Visit <http://deadpresident.blogspot.com> for more reports!

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 (22.7x FY08E 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.

Visit <http://deadpresident.blogspot.com> for more reports!

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.

Visit <http://deadpresident.blogspot.com> for more reports!

❑ **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 biogenetics 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.

Visit <http://deadpresident.blogspot.com> for more reports!

▣ 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 market 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 (22.7x FY08E 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

Analyst	Sector/Industry/Coverage	E-mail	Tel. +91-22-6638 3300
Pathik Gandotra	Head of Research; Banking, Strategy	pathik@sski.co.in	91-22-6638 3304
Shirish Rane	Cement, Construction, Power, Real Estate	shirish@sski.co.in	91-22-6638 3313
Nikhil Vora	FMCG, Media, Retailing, Mid Caps	nikhilvora@sski.co.in	91-22-6638 3308
Ramnath S	Automobiles, Auto ancillaries	ramnaths@sski.co.in	91-22-6638 3380
Nitin Agarwal	Pharmaceuticals	nitinagarwal@sski.co.in	91-22-6638 3395
Ganesh Duvvuri	IT Services, Telecom	ganesh@sski.co.in	91-22-6638 3358
Varatharajan S	Oil & Gas, Engineering	varatharajan@sski.co.in	91-22-6638 3240
Chirag Shah	Textiles, Metals, Real Estate	chiragshah@sski.co.in	91-22-6638 3306
Bhoomika Nair	Construction, Power, Logistics	bhoomika@sski.co.in	91-22-6638 3337
Avishek Datta	Oil & Gas, Engineering	avishek@sski.co.in	91-22-6638 3217
Bhushan Gajaria	FMCG, Retailing, Media	bhushangajaria@sski.co.in	91-22-6638 3367
Shreyash Devalkar	IT Services, Telecom	shreyashdevalkar@sski.co.in	91-22-6638 3311
Nilesh Parikh, CFA	Banking	nilesh@sski.co.in	91-22-6638 3325
Veekesh Gandhi	Banking	veekesh@sski.co.in	91-22-6638 3231
Ashish Shah	Automobiles, Auto ancillaries	ashishshah@sski.co.in	91-22-6638 3371
Salil Desai	Cement, Infrastructure	salil@sski.co.in	91-22-6638 3373
Rahul Narayan	FMCG, Retailing, Media	rahulnarayan@sski.co.in	91-22-6638 3238
Suchit Sehgal	Mid Caps	suchitsehgal@sski.co.in	91-22-6638 3307
Nityam Shah	Automobiles, Auto ancillaries	nityam@sski.co.in	91-22-6638 3327
Ritesh Shah	Textiles, Metals, Real Estate	riteshshah@sski.co.in	91-22-6638 3376
Dharmendra Sahu	Database Manager	dharmendra@sski.co.in	91-22-6638 3382

Equity Sales/Dealing	Designation	E-mail	Tel. +91-22-6638 3300
Naishadh Paleja	CEO	naishadh@sski.co.in	91-22-6638 3211
GV Alankara	Head of Dealing	alankara@sski.co.in	91-22-6638 3201-210
Vishal Purohit	VP - Sales	vishalp@sski.co.in	91-22-6638 3212
Nikhil Gholani	VP - Sales	nikhilgholani@sski.co.in	91-22-6638 3363
Sanjay Panicker	VP - Sales	sanjaypanicker@sski.co.in	91-22-6638 3368
V Navin Roy	AVP - Sales	navin@sski.co.in	91-22-6638 3370
Rohan Soares	AVP - Sales	rohan@sski.co.in	91-22-6638 3310
Rishi Kohli	VP - Derivatives	rishikohli@sski.co.in	91-22-6638 3321/403
Pawan Sharma	AVP - Derivatives	pawansharma@sski.co.in	91-22-6638 3403
Dipesh Shah	AVP - Derivatives	dipeshshah@sski.co.in	91-22-6638 3403
Manohar Wadhwa	AVP - Derivatives	manohar@sski.co.in	91-22-6638 3403

Disclaimer

This document has been prepared by S S Kantilal Ishwarlal Securities Private Limited (SSKI). SSKI and its subsidiaries and associated companies are full-service, integrated investment banking, investment management and brokerage group. Our research analysts and sales persons provide important input into our investment banking activities.

This document does not constitute an offer or solicitation for the purchase or sale of any financial instrument or as an official confirmation of any transaction.

The information contained herein is from publicly available data or other sources believed to be reliable. While we would endeavor to update the information herein on reasonable basis, SSKI, its subsidiaries and associated companies, their directors and employees ("SSKI and affiliates") are under no obligation to update or keep the information current. Also, there may be regulatory, compliance, or other reasons that may prevent SSKI and affiliates from doing so.

We do not represent that information contained herein is accurate or complete and it should not be relied upon as such. This document is prepared for assistance only and is not intended to be and must not alone be taken as the basis for an investment decision. The user assumes the entire risk of any use made of this information. Each recipient of this document should make such investigations as it deems necessary to arrive at an independent evaluation of an investment in the securities of companies referred to in this document (including the merits and risks involved). The investment discussed or views expressed may not be suitable for all investors.

Affiliates of SSKI may have issued other reports that are inconsistent with and reach different conclusion from the information presented in this report.

This report is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject SSKI and affiliates to any registration or licensing requirement within such jurisdiction. The securities described herein may or may not be eligible for sale in all jurisdictions or to certain category of investors. Persons in whose possession this document may come are required to inform themselves of and to observe such restriction.

Reports based on technical analysis centers on studying charts of a stock's price movement and trading volume, as opposed to focusing on a company's fundamentals and as such, may not match with a report on a company's fundamentals.

SSKI & affiliates may have used the information set forth herein before publication and may have positions in, may from time to time purchase or sell or may be materially interested in any of the securities mentioned or related securities. SSKI and affiliates may from time to time solicit from, or perform investment banking, or other services for, any company mentioned herein. Without limiting any of the foregoing, in no event shall SSKI, any of its affiliates or any third party involved in, or related to, computing or compiling the information have any liability for any damages of any kind. Any comments or statements made herein are those of the analyst and do not necessarily reflect those of SSKI and affiliates.

This Document is subject to changes without prior notice and is intended only for the person or entity to which it is addressed to and may contain confidential and/or privileged material and is not for any type of circulation. Any review, retransmission, or any other use is prohibited.

Though disseminated to all the customers simultaneously, not all customers may receive this report at the same time. SSKI will not treat recipients as customers by virtue of their receiving this report.

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:

1. SSKI and its affiliates have not received compensation from the company covered herein in the past twelve months for Issue Management, Capital Structure, Mergers & Acquisitions, Buyback of shares and Other corporate advisory services.
2. Affiliates of SSKI are currently not having any mandate from the subject company.
3. SSKI and its affiliates do not hold paid up capital of the company.
4. The Equity Analyst and his/her relatives/dependents hold no shares of the company covered as on the date of publication of research on the subject company.

Copyright in this document vests exclusively with SSKI