Company In-Depth

2 March 2007 | 13 pages

Dr Reddy (REDY.BO)

Buy: Core Growth Encouraging; Attractive Valuations

Rating change ☐
Target price change ☑
Estimate change ☑

- Raising target price; attractive valuations — We raise our target price on DRL by 3.2% to Rs803/share on a roll-over to 20x FY08E EPS. We reiterate that DRL's pragmatic approach to balance long-term ambition with profitability objectives will create value for investors. Having declined 18% over the last 2 months, the stock is at an attractive 18.8x FY08E recurring EPS.
- Raising estimates — We raise our EPS estimates for FY07-09E by 28%, 9% and 14% respectively. The revisions are on the back of: a) Zofran exclusivity (in FY07 & FY08); b) Imitrex authorized generic (in FY09); c) higher base business estimates; d) recent ADS issue. We highlight that since most of the upside is driven by "one-time" factors, the impact on our target price is marginal.
- Robust growth in base business — While AG deals were the key growth drivers, we believe these mask the robust growth in DRL's base business (28% YoY in 9mFY07). We expect this trend to sustain and drive continued growth in recurring earnings going forward
- Adding growth drivers — by way of several initiatives such as a) tie-ups for injectables, opthalmics etc where DRL lacks capabilities; b) focus on biosimilars; c) new markets such as Australia / NZ and Japan
- Monetizing uncertain opportunities — DRL has been turning uncertain upsides into tangible ones by converting P-IV filings into AG deals, implying lower legal costs and uncertainty. We expect some upside to come through every year – after Zocor & Proscar in FY07, Imitrex is tied up for FY09 and DRL has indicated that it may be able to tie up something for FY08 by mid CY07

See Appendix A-1 for Analyst Certification and important disclosures.

Buy/Medium Risk	1M
Price (01 Mar 07)	Rs662.95
Target price	Rs803.00
from Rs778.50	
Expected share price return	21.1%
Expected dividend yield	0.6%
Expected total return	**21.7%**
Market Cap	Rs111,310M
	US$2,525M

Price Performance (RIC: REDY.BO, BB: NDRRD IN)

Statistical Abstract

Year to 31 Mar	Net Profit (RsM)	Diluted EPS (Rs)	EPS growth (%)	P/E (x)	P/B (x)	ROE (%)	Yield (%)
2005A	212	2.77	-91.4	nm	2.4	1.0	0.5
2006A	929	12.11	337.6	54.7	2.3	4.3	0.5
2007E	8,327	49.66	310.0	13.4	2.8	26.7	0.6
2008E	6,505	38.79	-21.9	17.1	2.4	15.1	0.7
2009E	7,714	46.00	18.6	14.4	2.1	15.7	0.7

Source: Powered by dataCentral

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Fiscal year end 31-Mar	2005	2006	2007E	2008E	2009E
Valuation Ratios					
P/E adjusted (x)	nm	54.7	13.4	17.1	14.4
EV/EBITDA adjusted (x)	nm	171.3	8.0	9.0	7.3
P/BV (x)	2.4	2.3	2.8	2.4	2.1
Dividend yield (%)	0.5	0.5	0.6	0.7	0.7
Per Share Data (Rs)					
EPS adjusted	2.77	12.11	49.66	38.79	46.00
EPS reported	2.77	12.11	49.66	38.79	46.00
BVPS	273.84	290.40	239.36	272.98	313.80
DPS	3.00	3.50	4.00	4.50	4.50
Profit & Loss (RsM)					
Net sales	19,472	23,562	63,062	54,524	62,597
Operating expenses	-19,351	-23,404	-52,850	-46,301	-52,744
EBIT	**122**	**158**	**10,212**	**8,223**	**9,853**
Net interest expense	43	1,118	-714	-800	-720
Non-operating/exceptionals	-58	-88	23	-40	-60
Pre-tax profit	**107**	**1,188**	**9,521**	**7,383**	**9,073**
Tax	94	-258	-1,200	-886	-1,361
Extraord./Min.Int./Pref.div.	11	-1	6	8	2
Reported net income	**212**	**929**	**8,327**	**6,505**	**7,714**
Adjusted earnings	212	929	8,327	6,505	7,714
Adjusted EBITDA	473	578	11,682	9,623	11,253
Growth Rates (%)					
Sales	-3.0	21.0	167.6	-13.5	14.8
EBIT adjusted	-93.2	29.7	6,363.6	-19.5	19.8
EBITDA adjusted	-78.3	22.1	1,921.2	-17.6	16.9
EPS adjusted	-91.4	337.6	310.0	-21.9	18.6
Cash Flow (RsM)					
Operating cash flow	**2,348**	**1,039**	**-8,262**	**6,874**	**5,007**
Depreciation/amortization	352	420	1,470	1,400	1,400
Net working capital	113	-1,873	-16,595	361	-2,709
Investing cash flow	**633**	**-34,524**	**-1,200**	**-900**	**-900**
Capital expenditure	-1,749	-1,873	-1,200	-900	-900
Acquisitions/disposals	0	0	0	0	0
Financing cash flow	**1,931**	**27,211**	**9,539**	**-868**	**-868**
Borrowings	2,520	6,322	0	0	0
Dividends paid	-432	-436	-757	-868	-868
Change in cash	**4,912**	**-6,274**	**77**	**5,106**	**3,239**
Balance Sheet (RsM)					
Total assets	**29,288**	**68,768**	**81,452**	**84,495**	**92,007**
Cash & cash equivalent	9,657	5,334	5,410	10,517	13,756
Accounts receivable	3,587	4,802	11,230	10,083	11,576
Net fixed assets	7,058	9,086	10,286	11,186	12,086
Total liabilities	**8,335**	**46,496**	**41,308**	**38,706**	**39,370**
Accounts payable	1,416	3,639	5,183	4,481	5,145
Total Debt	2,827	30,995	24,263	22,363	22,363
Shareholders' funds	**20,953**	**22,272**	**40,138**	**45,775**	**52,622**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	2.4	2.5	18.5	17.6	18.0
ROE adjusted	1.0	4.3	26.7	15.1	15.7
ROIC adjusted	2.0	-0.8	43.6	28.7	31.9
Net debt to equity	-32.6	115.2	47.0	25.9	16.4
Total debt to capital	11.9	58.2	37.7	32.8	29.8

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Powered by: dataCentral

Core Growth Encouraging; Attractive Valuations

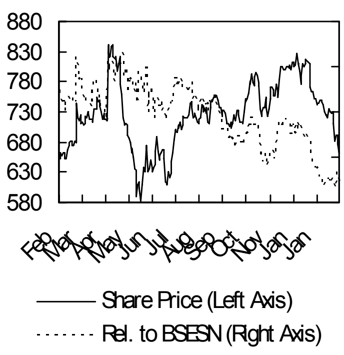
We raise our target price on DRL by 3.2% to Rs803/share on a roll-over of our base business valuation to 20x FY08E EPS. We reiterate that DRL's pragmatic approach to balance long term ambition with profitability objectives would create value for investors. Having declined 18% over the last 2 months, the stock is attractive at 18.8x FY08E recurring EPS. Maintain Buy/Medium Risk (1M) rating.

Figure 1. Stock Performance

(%)	3M	6M	12M
Absolute	(14.0)	(10.8)	0.2
Rel. to .BSESN	(9.5)	(20.2)	(19.5)

Source: Powered by dataCentral

Figure 2. Price Performance



Source: Powered by dataCentral

Figure 3. Earnings Revision

31-Mar	Old	New	Change (%)
Revenue			
2007E	51,329	63,062	22.9
2008E	49,757	54,524	9.6
2009E	55,846	62,597	12.1
EPS			
2007E	38.7	49.7	28.2
2008E	35.5	38.8	9.4
2009E	40.4	46.0	14.0

Source: Citigroup Investment Research

Attractive valuations

DRL has declined by 18.3% in absolute terms over the last two months, in the process underperforming the BSE Sensex by 12.6%. In the process, the stock has fallen to c6% below our fair valuation for its base business. The stock currently trades at attractive valuations of 18.8x FY08E recurring EPS. After factoring in the option value for its patent challenge pipeline and new drug discovery research efforts, we find c20% upside to our revised target price of Rs803/share.

Well balanced business model

We believe that DRL's business model is among the best placed to thrive within the changing dynamics of the pharma industry. It's well diversified revenue mix (generics, branded formulations, APIs and CPS) and expanding pipeline of products / markets within each segment would stand it in good stead to deliver robust growth over the medium term. At the same time, its ability to invest in areas such as biosimilars and new drug discovery research is likely to throw up growth and valuation drivers beyond the traditional generics opportunity over the longer term.

In our view, over the last few quarters, the various moving parts within the business (Betapharm, authorized generics for simvastatin, finasteride, semi-exclusivity in fexofenadine and ondansetron exclusivity) have masked the improvement seen in the underlying base business across most segments and markets. We expect this to come to the fore over the next year, as the one-time upsides disappear.

Raising earnings and target price

We raise our EPS estimates for FY07-09E by 28%, 9% and 14% respectively. We also upgrade our target price for DRL by 3.2% to Rs803 / share on roll over of valuation of its base business to 20xMarch08E earnings.

Our earnings revision is on the back of the following factors:

- Zofran exclusivity – affects FY07 and FY08 earnings
- Imitrex authorized generic – five months of AG sales assumed in FY09
- Higher base business estimates – driven by better than expected growth in branded formulations and APIs as well as the delay in competition for fexofenadine
- Recent ADS issue – leading to additional equity shares of 14.3m

We highlight that since most of the upside is driven by "one-time" factors, the impact on our target price is marginal.

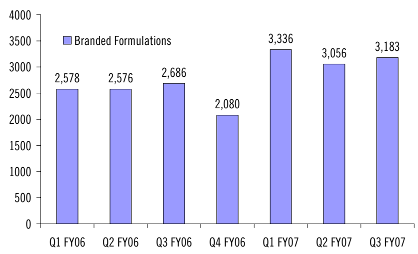
Meeting with Management – Positive Takeaways

We met the management recently and came away with some positive takeaways. Key highlights include:

Building steady, cash flow generating businesses

DRL is focusing on building branded formulations, international APIs and custom pharmaceutical services (CPS) as stable, cash flow generating businesses with steady growth – thereby allowing it to invest appropriately more volatile areas such as patent challenges, biosimilars and R&D.

Figure 4. Branded Formulation Revenues



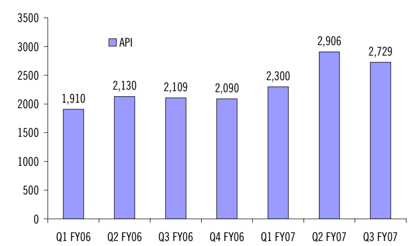
Source: Company Reports

- Branded Formulations – growth momentum is expected to sustain, especially in Russia/CIS and India. In Russia, the share of hospitals business and OTC in DRL's overall revenues has increased to around 25% now, opening up new avenues of growth. The troubles related to the DLO program would not hurt DRL, since it had virtually nil exposure to this segment.

  DRL is also in a good position to sustain its newfound growth in the Indian market, as it continues to launch innovative combinations and looks at spreading into smaller towns and rural areas, where penetration is on the rise. The number of MRs on DRL's rolls has increased to c1400 from c900 two years ago. Since these markets do not require too much incremental investment, we expect some operating leverage benefits to play out at the gross margin level.

  DRL is also looking at other key markets such as Australia / NZ and Japan - to tap with the same products that they are taking to the US and Europe.

Figure 5. API Revenues



Source: Company Reports

- APIs – DRL is confident of growing on the high FY07 base (due to supply of sertraline to Teva during US exclusivity), although they did not provide any specific data in this regard. This came as a positive surprise to us, as we were expecting a decline in API revenues once the sertraline exclusivity runs out. However, gross margins that have gone up to c36% in FY07 would once again come down to the 30-35% range with sertraline sales and pricing expected to decline post the loss of exclusivity for Teva.

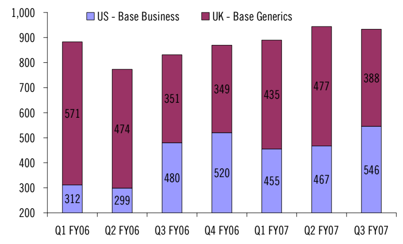
- CPS business – post acquisition of Roche's facility in Mexico, the business has crossed the US$100m mark and the company is confident of doubling revenues over the next three years.

Besides building on these stable businesses, DRL is also working towards ensuring that their five key revenue streams – US generics; EU generics; CPS; International APIs and branded formulations contribute evenly to revenues – so as to ensure adequate diversification in the business.

Regulated market generics – on the growth path again

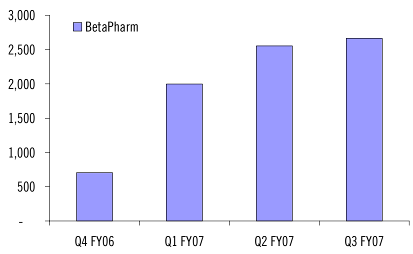
After a phase of decline and consolidation in the regulated markets of US and Europe, we believe that DRL is well set to once again get on the growth path. While an increasing number of product launches would lead to a rapid scale up in the US generics revenues, a relative stabilization of pricing in Germany would allow volume growth in this market to translate into higher revenues and profits.

Figure 6. Base Generic Revenues



Source: Company Reports

Figure 7. Betapharm Revenues



Source: Company Reports

- US generics: We expect the growth momentum in the US core business to continue over the next few years. DRL is in the process of scaling up the number of products that they have in the market. They expect a minimum of 6-8 launches in the US market over FY08 – key ones being ziprasidone, omeprazole, terbinafine, amlodipine besylate, cipro-XR and risperidone are some of the likely product launches. The company has one of the strongest ANDA pipelines with 58 ANDAs pending approval and 33 Para IVs. Fexofenadine (Allegra), which they launched at risk continues to be a good product for the company. The management is not certain why further competition has not come in yet; however expects this to happen any time.

  Besides, DRL is looking at expanding their offerings in the regulated markets by tying up with other players to get into areas such as injectibles, opthalmics etc where they do not have capabilities in-house (for instance with DSM for injectables). These could throw up commercial opportunities as early as 12-15 months out and add to growth rates.

- Germany – the worst is behind: We believe that the worst is behind as far as Betapharm is concerned. The big impact in terms of price cuts has already been absorbed and is factored into earnings and valuations, in our view. While there would continue to be some further changes in pricing on the basis of various factors, these are likely to be largely in the form of small adjustments that are manageable. We note that despite the sharp price cuts in FY07, Betapharm revenues have been flat YoY, implying a c15% growth in volumes. With the pricing now likely to stabilize, we expect the volume growth to translate into higher revenues and profits.

  More importantly, the management indicated that they may probably be able to expedite the integration of manufacturing operations into DRL's facilities. This, we believe, would be a strong positive for profitability of the business. However, in the interim, we believe that gross margins on this business have very little scope of moving up. We expect GMs to remain flat or even decline marginally going forward for the next few years.

  We believe that the price cuts in Germany may prompt the company to take a call on impairment of goodwill. The management indicated that this is an annual exercise and, as things stand today, they do not see any reason that would compel them to take a hit as their assumptions on discounted future cash flows are still achievable. However, we believe that this is something that cannot be totally ruled out, as it is a management decision that can be taken closer to the year end. We have not incorporated any goodwill write-off into our estimates, at the moment.

Continued focus on patent challenges:

DRL intends to continue focusing on patent challenges in the USA, as it remains a profitable opportunity. However, the company would continue to look for ways to monetize these opportunities and make them more certain. DRL is working towards ensuring that there is some incremental earnings from this front every fiscal – in FY07 they had Zocor, Proscar and Ondansetron; in FY09, they will have Imitrex (settled with GSK). They are looking at options to fill the gap in FY08 for which some clarity may emerge in the second half of CY07.

This is a smart approach, in our view, as it implies relatively lower legal costs and uncertainty. We are not too worried about moves to curtail the settlement process or authorized generics in the USA. While the latter would improve the valuation of DRL's first to file pipeline significantly, we note that the legislation to curtail reverse payment settlements does not aim to prohibit settlements that allow the first generic filer to enter the market prior to patent expiry. None of DRL's settlements with innovators so far have involved reverse payments that could be at risk.

DRL's current first to file pipeline addresses a branded market of US$11bn. In terms of specific challenges:

- The appeal process for Risperdal (risperidone, which DRL has lost in the lower court) is on; however, this may not ultimately matter since the patent expiry is in December 2007.
- In Exelon (rivastigmine), where DRL appears to have joint exclusivity with Watson and Sun Pharma, the company has decided to stay their court proceedings since their arguments are similar to those of Watson & Sun
- Lower court proceedings could commence towards the end of CY07 in litigations related to Keppra (levetiracetam), Avandia (Rosiglitazon Maleate) and Aciphex (Rabeprazole Sodium)

Biosimilars & NCEs – longer term growth drivers

Besides shoring up growth rates over the medium term through broad basing their revenue streams and expanding in key markets, DRL continues to invest in drug discovery research and potential sunrise areas such as biosimilars to drive longer term growth. We believe this is absolutely necessary, as generic companies would need new growth drivers to take them forward once the traditional generics opportunity starts drying up around 5-7 years down the line.

- Biosimilars – The management believes that they have the capability in-house to develop biosimilars. We believe that the challenge for the company would be how to time the entire strategy (particularly in terms of capital investment, product related spend etc), as the timeline on market entry in regulated markets is still highly uncertain. DRL intends to start with launching their products in India and other less regulated markets, so that revenues and earnings start to come through – while expansion of capacities would be done in line with the expected timeline for entry into European markets. The management has already announced that they are working on 10 molecules – interestingly, this does not include insulin and EPO, implying that some of the products that they are working towards are the more complex ones for which the regulatory pathway may take even longer to establish in regulated markets. We believe that the visibility on the company's pipeline would start improving from CY07. They are already selling GCSF in India and are in a position to launch at least one biosimilar every year from CY07 in the Indian market. These are the same products that they intend to take into regulated markets going forward. In our view, although DRL is a relatively late entrant in this space vis-à-vis some of their Indian peers, they are likely to have reasonable time to catch up (especially in the US market), given the continuing uncertainty over the regulatory pathway.

- **Drug discovery research** – Perlecan Pharma now has 3 molecules in clinical trials and one in the pre-clinical phase. DRL's holding in Perlecan Pharma has not changed till date (still at c14%). The management indicated that if everything goes well on all four molecules (i.e. progress to phase 2a and out licensed), DRL's stake would go to a maximum of 67%. In any case (complete success, complete failure or partial success / failure) the entire process would play out over the next three years.

  In terms of their own spend on drug discovery, the company has some limits in mind, beyond which it will not allow R&D spend to escalate. Within these limits, however, they would try to maximise the effort. The co-development deals that they have entered into with Rheoscience (for balaglitazone) and Clintec International (for DRF-1042) are efforts to strike a balance between potential upside and related risk. For Balaglitazone, the management indicated that the first dose on humans is scheduled for October / November, while full scale human trials could take around a year to commence. If everything goes well, DRL could look at a launch in 2010.

  However, on the generics R&D front, we believe there is likely to be a step up in cost from the next fiscal (FY08), as DRL is unlikely to utilize the second tranche of the deal with ICICI Ventures

Dr Reddy's

Company description

DRL is a leading pharma company in India, with one of the best R&D pipelines. It focuses on value addition by increasing the share of branded formulations and generics exports to regulated markets. After starting as a bulk-drugs player in 1984, it has moved up the value chain and is aiming to become an innovator company. In generics, it is trying to increase the share of sales from regulated markets to boost overall profitability. As part of its inorganic growth strategy, it acquired Betapharm in Germany and is looking at smaller deals going forward.

Investment thesis

We rate DRL Buy (1M) with a target price of Rs803 / share. We believe the company has evolved a business model that is among the best placed to tackle the changing dynamics of the industry. A right mix of near term growth drivers and investment for longer term sustainability of growth make DRL one of the best plays in the Indian pharma industry, in our view. Over the last few quarters, a slew of one time opportunities and inorganic initiatives have masked the strong growth witnessed in the core base business. We expect this to become visible over the next few quarters and provide support to valuations. At the same time, DRL’s presence in patent challenges and drug discovery imply that potential positive surprises to earnings and valuations cannot be ruled out.

Valuation

Valuing DRL is a challenge, as besides its base generics business, it also has a high exposure to patent challenges and NCE research, where costs are front ended and returns likely to come through in future. As such, a pure P/E based approach would be insufficient and we use sum-of-the-parts to value. We use P/E to value the base business. DRL has brought its cost structure under control by sharing R&D costs and upside with partners and other cost control measures. Besides, rising revenues have seen benefits of operating leverage come through. We therefore believe that P/E is the best valuation method for DRL. We use a target multiple of 20x to value sector leaders, which is at a premium of about 40% to the broad market. The premium is justified, in our view, as the sector is IPR driven and has the potential to spring earnings triggers that could lead to significant growth in future. At 20x March'08E (20x June' 07E earlier) earnings, we value DRL's base business at Rs703 / share (v/s Rs684/share earlier). We value DRL's Para IV pipeline and drug discovery efforts separately at Rs31/share (v/s Rs26/share earlier). For patent challenges we use a higher success probability of 20% (v/s 15% earlier), and a discounted cash flow (discount factor 15%) for the opportunities being targeted by the company over the next few years. We use a higher probability, given the company's recent efforts to settle litigations with innovators, thus increasing the certainty of these opportunities. We also maintain our valuation of Rs68/share for DRL's new drug discovery efforts. The sum of these measures gives us a target price of Rs803/share (v/s Rs779/share earlier).

Risk

We rate DRL Medium Risk in recognition of the steady growth of the base business and the longer-term potential for cash flows from research-based opportunities. The downside risks to our target price include: (1) DRL's ramp-up in sales and distribution in the US market entails large investments; (2) Patent challenges are win-lose situations and often cause volatile stock price movements; and (3) R&D success rates are low

Appendix A-1

Analyst Certification

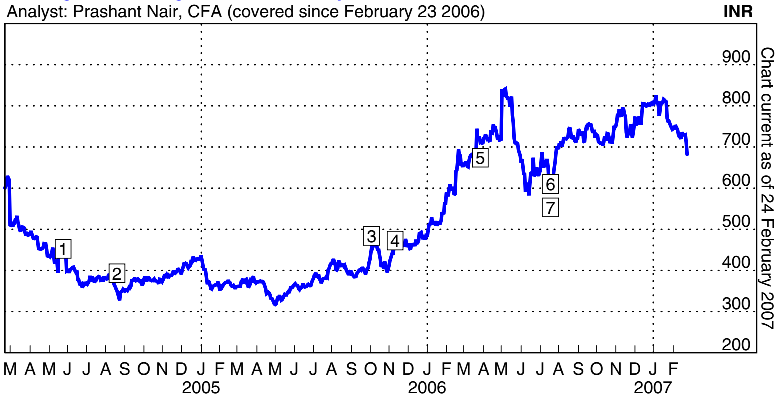
I, Prashant Nair, CFA, research analyst and the author of this report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject issuer(s) or securities. I also certify that no part of my compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report.

IMPORTANT DISCLOSURES

Dr Reddys Laboratories (REDY.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Prashant Nair, CFA (covered since February 23 2006)



#	Date	Rating	Target Price	Closing Price
1:	25 May 04	*1L	500.00	437.77
2:	19 Aug 04	1L	*475.00	350.27
3:	4 Oct 05	1L	*534.00	455.65
4:	10 Nov 05	1L	*593.50	457.27
5:	28 Mar 06	*3M	*758.00	711.20
6:	19 Jul 06	*1M	*778.50	610.00
7:	19 Jul 06	1M	778.50	610.00

*Indicates change.

Covered
Not covered

Teva (TEVA.O)

Ratings and Target Price History - Fundamental Research

Analyst: Robert Bonte-Friedheim

#	Date	Rating	Target Price	Closing Price
1:	28 Jun 04	*1M	*41.50	33.59
2:	8 Jul 04	1M	41.50	33.51
3:	21 Sep 04	*2M	*30.00	27.20
4:	17 Feb 05	*3M	*25.00	26.92
5:	1 Mar 05	3M	*27.00	29.87
6:	26 Jul 05	*2M	*34.00	31.95
7:	24 Apr 06	*1H	*51.00	39.76
8:	6 Jul 06	1H	*46.00	32.04

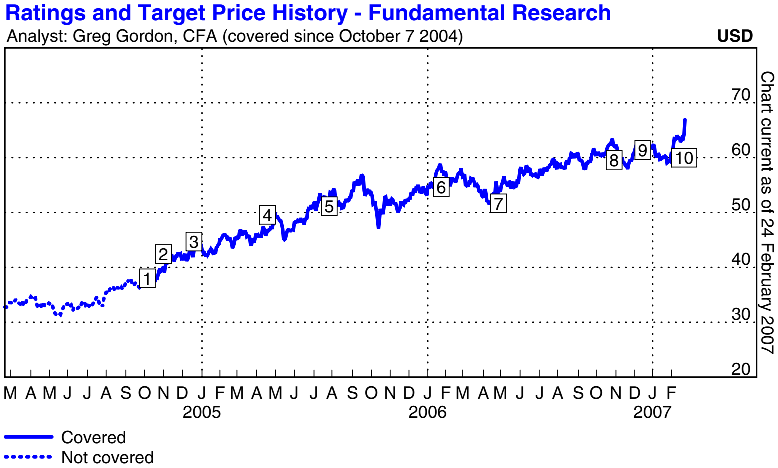
*Indicates change.

Covered
Not covered

Exelon Corp. (EXC)

Ratings and Target Price History - Fundamental Research

Analyst: Greg Gordon, CFA (covered since October 7 2004)



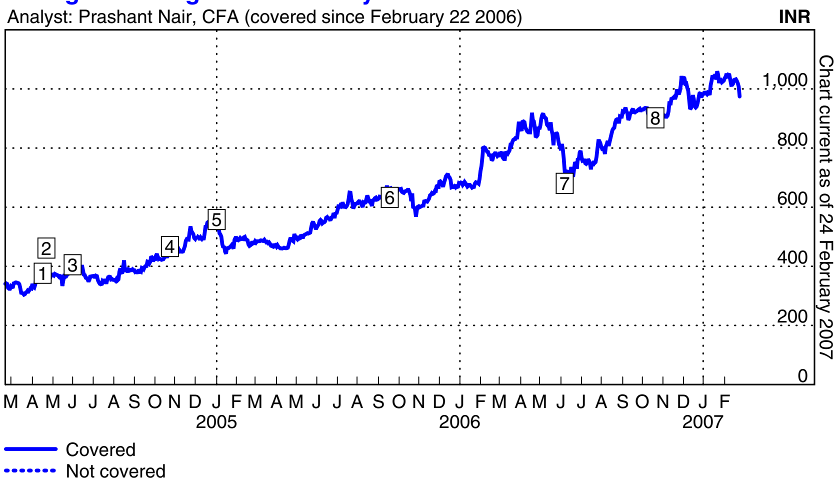
#	Date	Rating	Target Price	Closing Price
1:	6 Oct 04	*2M	*40.00	38.00
2:	31 Oct 04	*1M	*45.00	40.17
3:	20 Dec 04	1M	*48.00	43.05
4:	19 Apr 05	1M	*54.00	46.95
5:	27 Jul 05	1M	*60.00	52.38
6:	25 Jan 06	1M	*70.00	57.84
7:	27 Apr 06	1M	*65.00	54.16
8:	29 Oct 06	*2M	65.00	62.09
9:	14 Dec 06	2M	*63.00	62.42
10:	22 Feb 07	*1M	*73.00	64.23

*Indicates change.

Sun Pharma (SUN.BO)

Ratings and Target Price History - Fundamental Research

Analyst: Prashant Nair, CFA (covered since February 22 2006)



#	Date	Rating	Target Price	Closing Price
1:	16 Apr 04	*2L	385.00	376.48
2:	22 Apr 04	2L	385.00	355.48
3:	1 Jun 04	2L	385.00	405.25
4:	25 Oct 04	2L	*460.00	453.10
5:	3 Jan 05	*3L	460.00	555.30
6:	19 Sep 05	3L	*480.00	663.10
7:	7 Jun 06	3L	*695.00	721.40
8:	20 Oct 06	3L	*764.00	912.45

*Indicates change.

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