

May 13, 2013

BSE Code: 500124 NSE Code: DRREDDY Reuters Code: REDY.BO Bloomberg Code: DRRD:IN

Dr. Reddy's Laboratories Limited (DRL), headquartered in Hyderabad, is an integrated pharmaceutical company with presence across the pharmaceutical value chain through its businesses of Pharmaceutical Services & Active Ingredients (PSAI), global generics and proprietary products. The company is among the leading domestic pharmaceutical companies with specialised focus on the research; currently developing bio-similars and New Chemical Entity's (NCE).

Investor's Rationale

We expect Global Generics revenues to grow at ~16% CAGR for FY12-FY15E primarily on the account of limited competitive product launches and grip in market share of existing products. US market, which contributed ~45% to the formulation sales in 9MFY13, is expected to remain a main growth driver. It has 65 Abbreviated New Drug Applications (ANDA) pending for approval, of which 35 are Para-IV filings (8 First to File (FTF)). Also, the company has developed its over the counter (OTC) product basket in US, which contributes ~USD 130 mn (in FY12), almost 25% to its overall sales.

DRL launched Zenatane, a generic version of Accutane drug, in March, 2013 and generic Zoledronic acid injection in early April 2013. Remarkably, each of the drugs is expected to have market size of ~USD 300 mn in US and is expected to contribute ~USD 25-30 mn to revenue (FY14E) after considering the competition and price erosion. Further, expected launch of anti-cancer drug Vidaza during FY14E may drive revenues significantly (estimated annual contribution of USD 50-60 mn to the revenues).

Russia and India business together contributes 39% to the formulation business and we expect it to grow at ~16% CAGR over FY12-15E. Strong OTC portfolio, biosimilar products and other new products launches will assist in growth. Revenues from bio-similars segment are expected to hit ₹1 bn mark in FY13.

PSAI business is likely to sustain firm growth, driven by patent expiries. Recently gained contracts have provided traction to the Custom Pharmaceuticals Services (CPS). Revenues from GSK deal are also expected to gain momentum.

Like other Generic players, delay in product approvals by USFDA, price controls by the government could adversely impact the profitability of the formulations business. However, the same is likely to offset from the higher volumes and improved traction in market share of existing products. However, DRL is committed to its long-term strategy to develop and market complex generic products in a focused manner to drive growth in the US market.

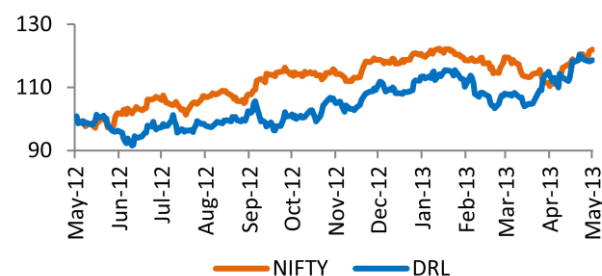
Market Data

Rating	BUY
CMP (₹)	2,091
Target (₹)	2,325
Potential Upside	~12.0%
Duration	Long Term
Face Value (₹)	5
52 week H/L (₹)	2,108/1,528.0
Adj. all time High (₹)	2,108
Decline from 52WH (%)	0.8
Rise from 52WL (%)	36.9
Beta	0.46
Mkt. Cap (₹ bn)	354.6
Enterprise Value (₹ bn)	355.5

Fiscal Year Ended

Y/E	FY12A	FY13E	FY14E	FY15E
Revenue (₹ bn)	98.1	114.3	132.5	149.1
EBITDA (₹ bn)	24.3	25.8	29.8	33.2
Net Profit (₹ bn)	13.0	15.7	18.5	20.8
Adj EPS (₹)	76.7	92.7	108.8	122.4
P/E (x)	27.3	22.6	19.2	17.1
P/BV (x)	7.1	5.6	4.5	3.6
EV/EBITDA (x)	14.6	13.5	11.3	9.9
ROCE (%)	28.4	25.5	25.2	23.8
ROE (%)	26.1	25.0	23.3	21.3

One year Price Chart



Shareholding Pattern

Shareholding Pattern	Mar'13	Dec'12	Diff.
Promoters	25.56	25.56	-
FII	29.66	26.17	3.49
DII	11.03	13.98	(2.95)
Others	33.75	34.29	(0.54)

OTC portfolio crossed a significant milestone of USD 200 mn and represents almost 10% of the DRL's total revenues.

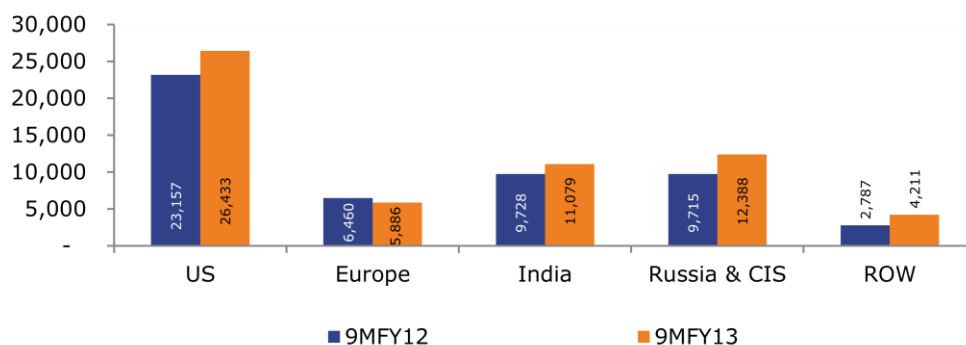
US contributed 44% of the consolidated formulations revenue followed by Russia and CIS countries (21%), India (18%), Europe (10%) and ROW (7%).

Robust formulation business to augment growth in FY13-FY15E

DRL has carved a position for itself in the formulations business segment by launching products with limited competition and building the strong OTC portfolio in US and Russian markets. The company successfully launched the generic version of the brand Zyprexa (blockbuster drug - used to treat schizophrenia & bipolar disorder) in the US market under 180-days market exclusivity and added ~USD 100 mn to its incremental revenues in FY12. During FY12 its OTC (Over-the-counter) portfolio crossed a significant milestone of USD 200 mn and represents almost 10% of the company's total revenues. After riding high on the success of OTC franchise in Russia and US, where OTC accounts for 30% and 25% of sales respectively in FY12, DRL is building the same model in India too.

Global Generics segment (includes branded & unbranded formulations and OTC pharmaceutical products) revenue grew 15.7% YoY to ₹60.0 bn in 9MFY13. Where, US contribute 44% of the consolidated formulations revenue followed by Russia and CIS countries (21%), India (18%), Europe (10%) and ROW (7%). The growth in the US market was driven by launch of key limited competition products such as Ziprasidone (FTF of the brand Geodon), Tacrolimus, Fondaparinux and ramp-up in antibiotics portfolio. The growth was further strengthened by gain in market share of products such as Atorvastatin, Metoprolol, Ibandronate and Montelukast granules. As per IMS, Nov 2012, the company's 31 products from the prescription portfolio are ranked among the Top 3 in their respective market shares. Revenue growth in Russian & other CIS markets were driven by ramp-up in market share of key brands, new product launches and OTC portfolio. Strong traction in biosimilars portfolio drives the revenue growth for India business.

Global Generics segment augmented 15.7% YoY in 9MFY13 (in ₹mn)



Niche launches to drive US business

US formulations business is the key ally for the profitability to the company contributing ~32% to the consolidated revenues. Healthy growth is driven by large number of Para IV and FTF launches. Over the years, DRL has also built its base business which is expected to be the key revenue growth driver over FY13-FY15E. In the US, it is also eyeing on limited competition products, which has aided to earn revenues worth USD 200 mn in FY12, equivalent to 10% of its total revenue. The acquisition of GSK's penicillin facility in US has also opened up newer revenue drivers for the company as it has entered into the penicillin based anti-bacterial segment through brands such as Augmentin and Amoxil. This facility is already earning profit at gross level and further ramp up of this new facility would add to the profitability.

Strong growth to be driven by large number of Para IV & FTF and limited competition launches by the company.

The New Launch of Zenatane and Zoledronic acid injection are expected to contribute ~USD 26-30 mn each to DRL's revenues in FY14E.

During H2FY13, DRL launched a couple of products which are expected to boost its high margins in US business. The company launched Zenatane (Isotretinoin; used for treatment of acne) capsules, a generic version of Accutane drug, in March, 2013 and generic Zoledronic acid (osteoporosis treatment drug) injection in early April 2013. Notably, each of the drugs having more than USD 300 mn market in the US is expected to contribute around ~USD 25-30 mn to DRL's revenues in FY14 (after factoring in the competition, as well as the price erosion).

Earlier, DRL launched Metoprolol extended-release generics (Toprol XL), used for the treatment of hypertension, in September 2012. The product has gained healthy response after the launch and has 11% market share in the US. It also launched the much awaited drug Propecia (Merck's benign prostatic hyperplasia product which have a market of USD 420 mn in US) in Jan 2013 (expected to garner ~USD 40-50 mn revenue in the exclusivity period). Launched generics of Zumeta, another osteoporosis treatment drug, in early March 2013, which is likely to contribute ~USD 10-15 mn/annum to DRL's US revenues. As per IMS, market share in key products are Tacrolimus (44%), Arixtra (29%) and Atorvastatin (15%).

DRL's key products and market share

Brand	Generic	Market Share	Market Size (USD mn)
Toprol	Metoprolol Succinate	2%	650
Zyprexa	Olanzapine	5%	450
Singulair	Monteculast	6%	300
Seroquel	Quetapine Fumurate	4%	250
Prevacid	Lansoprazole	22%	200
Prograf	Tacrolimus	44%	180
Arixtra	Fondaparinux	28%	170
Lipitor	Atorvastatin	16%	150
Geodon	Ziprasidone	32%	130
Augmentin	Amox+Clauv	35%	100
Boniva	Ibandronate	15%	50

Strong product pipeline ~65 ANDAs are pending approval with the USFDA, include 35 Para-IVs (8 FTFs).

We expect revenues from US to grow at a faster pace over next two years with the pick-up in the momentum of new product approval and launches. US business is likely to further scale up on the back of a strong product pipeline ~65 ANDAs are pending approval with the USFDA, include 35 Para-IVs (8 FTFs).

DRL guides at least ~30% of new filings to be in complex and niche areas. Vidaza, Dacogen and a couple of niche opportunities are some of the pending approvals over the next few months, which should accelerate the growth. Launch of anti-cancer drug Vidaza during FY14, could drive revenues significantly (estimated annual contribution of ~USD 50-60 mn to the total revenue).

We believe healthy market share in existing products, recent products launched and pending ANDAs approval to augment growth over FY13-F15E.

Exclusive Para IV/FTF opportunities for DRL

Brand	Innovator	Generic	Brand Revenues (USD mn)	Launch date
Zyprexa 20mg	Astrazeneca	Olanzipine	900	Launched
Geodon	Pfizer	Ziprasidone HCL	800	Launched
Seroquel	Sunovion/Sepracor	Quetiapine	3,300	Launched
Plavix	GSK	Clopidogrel Bisulfate	6,666	Launched
Boniva	Schering Plough	Ibandronate	500	Launched
Propecia	Merck	Finasteride	420	Launched
Aciphex	Takeda	Rabeprazole	800	FY14
Clarinx 5mg	Merck	Desloratidine	150	FY14
Avelox	Sanofi Aventis	Moxifloxacin HCL	350	FY14
Lunesta	Roche	Eszopiclone	785	FY14

OTC segment now accounts for almost 30% of Russian revenues.

Nise, Omez, Ketorol, Ciprolet and Senade are market leaders in their respective segments.

Partnered with R-Pharma for technical know-how in the Russian pharma market.

OTC business to continue drive growth in Russia and CIS markets

Russia and CIS region are the 2nd largest market for DRL (account for 15% of the total revenues in 9MFY13) after US. Revenues in these markets grew 27.5% YoY in 9MFY13 to ₹12.4 bn driven by both OTC and prescription products. The company has built strong product portfolio in the market including Nise, Omez, Ketorol, Ciprolet and Senade, maintaining their position as a market leaders in their respective segments. Besides launching its own products, DRL has expanded its portfolio through various in-licensing deals with partners for exclusive marketing rights. It has been steadily scaling up its presence in the OTC segment (now accounts for ~30% of Russian revenue) to hedge against regulatory risks. Focus on selected therapies such as gastro-intestinal, pain, anti-infectives, dermatology and cardiovascular and a higher consumer mix have assisted DRL's Russian operations consistently to outperform in the industry.

Growing trend of key brands in Russia

(in ₹mn)	FY11	FY12	% YoY Growth
Nise	2,311	3,145	36%
Omez	1,554	1,877	21%
Ketorol	1,376	1,574	14%
Ciprolet	778	839	8%
Senade	598	692	16%

Russian pharmaceutical market is valued nearly at ~USD 15 bn. OTC segment stands at 50% other total Russian pharmaceutical market, by value and 73% by volume. In the central and eastern European region, Russia is the largest OTC market and has registered the highest change of 23% YoY in per capita OTC expenditure. Russia further aims at shifting to local production of at least 50% of the imported drugs by FY20. To cope up with the changing environment, DRL has partnered with R-Pharma (a Russian pharma company) to make drugs with technical know-how. The company is further scouting for acquisitions to strengthen their presence in the Russian market.

Domestic business is expected to grow in-line with industrial growth rate of ~13.4% CAGR over FY12-15E.

Gastro-intestinal (GI), pain/analgesics and anti-infective lead the therapeutic basket.

Bio-similars segment's revenue are expected to hit ~₹1 bn mark in FY13. The management expects bio-similars to contribute ~USD 100 mn annually from emerging markets by the end of FY15E.

GI and CVS therapeutic segments to drive domestic market growth

DRL's revenue contributes 13% to Indian formulation business. The company's portfolio composition is skewed towards acute therapies. Around 60% of its domestic revenue comes from acute therapies, while the rest 40% from chronic therapies. Gastro-intestinal (GI), pain/analgesics and anti-infective lead the therapeutic basket. Product combinations such as Razo D and Omez D in GI have propelled performance. Further, top 10 brands, which typically account for ~36% of domestic sales, grew at a slower pace of 6.5% in FY12. However, the company has managed to grow in-line with industry growth rate led by 54% increase in field force over the last 4 years. Thus, we expect domestic business to grow in-line with industry growth rate of ~13.4% CAGR over FY12-15E on the back of new launches, ramp up in existing product portfolio & improvement in productivity.

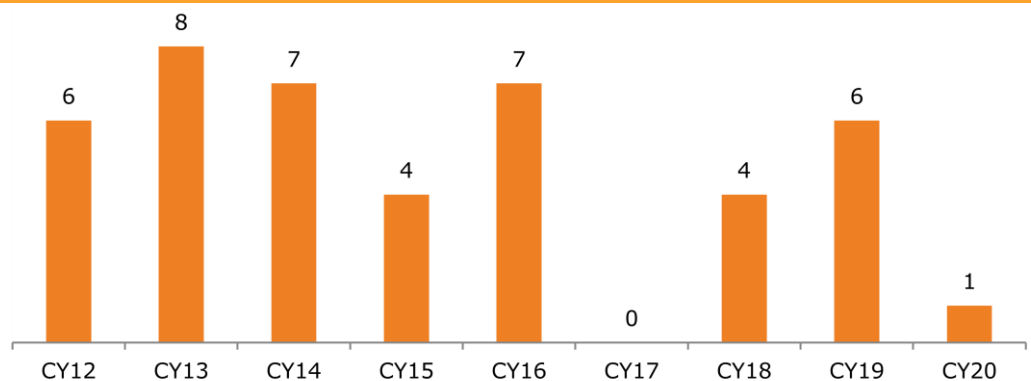
DRL's key brands and sales (in ₹mn)

Brand	Therapy	FY08	FY09	FY10	FY11	FY12	CAGR (FY08-FY12)
Omez Group	GI	929	986	1,238	1,442	1,557	13.8%
Nise	Pain/analgesic	880	605	690	700	596	(9.3%)
Stamlo Group	CVS	708	723	799	835	924	6.9%
Reditux	Oncology	154	199	232	405	471	32.2%
Razo Group	GI	180	352	416	485	555	32.5%
Atocor	CVS	244	269	274	278	311	6.3%
Mintop	Derma	150	172	196	209	225	10.7%

Bio-similars business add impetus to growth

Revenues from bio-similars segment are expected to hit ~₹1 bn mark in FY13. Bio-similars offers a huge opportunity as patents worth USD 37 bn are going off patent from 2013E-2020E. Further, the segment draws limited competition as these drugs are more complicated to replicate and so the price erosion on the drugs will lesser at 25-50%, unlike generic drugs, where price erosion is generally upto 90%. DRL was the earlier entrant in the segment with the launch of Reditux, used in the treatment of certain lymphomas, leukemia and rheumatoid arthritis. The current bio-similars portfolio of the company comprises (i) filgrastim, (ii) pegfilgrastim, (iii) rituximab and (iv) darbepoetin alfa, with commercial presence in 13 countries among emerging markets. The management expects bio-similars to contribute ~USD 100 mn annually from emerging markets by the end of FY15E.

Biologics product patent expiries (in USD BN)



PSAI revenues grew 25.7% YoY to ₹20,530 mn in 9MFY13 on the back of number of product patent expiries in US and Europe and traction in CPS business.

Tied-up with Fujifilm for developing, manufacturing and promoting generic drugs in Japan.

DRL has 29 active products in the pipeline, of which 7 were in clinical development.

Global generics segment is expected to register approx. 16% CAGR over FY12-FY15E.

Traction in CPS business and product patent expiries augurs well

PSAI segment comprises of API and CPS. In 9MFY13, revenues from the PSAI segment grew 25.7% YoY to ₹20,530 mn on the back of number of product patent expiries in US and Europe. Also, the company reported good growth in the CPS business led by new contract. Revenue from Europe grew 34.8% YoY to ₹7,611 mn, largely on account of traction in product launches (ibandronate sodium and escitalopram) last year, and higher sales from existing products. Revenue from India, US and ROW grew 33.0%, 19.6% and 16.6% respectively, driven by increased sales from existing products.

During FY10, DRL entered into an agreement with GSK to develop and market selected products across emerging markets outside India. DRL is responsible for manufacturing, products are likely to be licensed and supplied to GSK in markets such as Latin America, Africa, the Middle East and Asia Pacific. We believe the momentum has already picked up and strong growth to be witnessed going forward.

Tied up with Fujifilm in Japan

The company has also forayed into Japan, the world's second largest pharmaceutical market, estimated to be ~USD 97 bn as per IMS research agency. Japan has lower penetration of generics in the market i.e. only 23% of Japanese prescription drug sales by volume comprise generics, versus 70% in the US. DRL has tied-up with Fujifilm, for developing, manufacturing and promoting generic drugs in Japan. The JV has 51% stake owned by Fujifilm, and 49% by DRL. It intends to launch its first product in Japan in the next three to four years.

Value creation through innovation

DRL has also focused aggressively on drug discovery and research. The company has 29 active products in the pipeline, of which 7 were in clinical development and 22 in the pre-clinical stage. It has built a pipeline of assets which could produce a steady stream of IND's in the coming years.

Formulations business to drive growth over FY13-FY15E

(in ₹mn)	FY11	FY12	FY13E	FY14E	FY15E
PSAI	19,648	23,812	28,327	32,767	36,269
Global Generics	53,340	70,243	82,763	96,066	108,727
US	18,996	31,889	37,862	44,854	50,909
Europe	8,431	8,259	7,797	8,109	8,514
India	11,690	12,931	14,737	16,698	18,869
Russia & CIS	10,858	13,260	16,598	19,598	22,538
ROW	3,365	3,904	5,769	6,807	7,897
Proprietary Products and others	1,705	2,682	3,185	3,653	4,071

Balance Sheet (Consolidated)

Y/E (₹mn)	FY12A	FY13E	FY14E	FY15E
Share Capital	848	849	849	849
Reserve and surplus	49,042	62,021	78,525	96,554
Net Worth	49,890	62,870	79,375	97,403
Long term debt	16,419	17,240	17,228	16,883
Other liabilities	495	545	549	577
Current liabilities	45,914	53,609	58,557	62,791
Long term provisions	333	407	494	560
Deferred Tax Liabilities	191	191	191	191
Total equity & liabilities	113,242	134,862	156,393	178,404
Investment	9	9	9	9
Fixed Assets	41,202	43,358	45,437	47,747
Loans & advances	701	877	1,053	1,225
Deferred Tax Assets	1,340	1,340	1,340	1,340
Current Assets	69,990	89,278	108,555	128,082
Total assets	113,242	134,862	156,393	178,404

Profit & Loss Account (Consolidated)

Y/E (₹mn)	FY12A	FY13E	FY14E	FY15E
Net Sales	98,145	114,275	132,486	149,066
Expenses	73,834	88,449	102,677	115,824
EBITDA	24,311	25,826	29,809	33,242
EBITDA margin (%)	25.8	22.6	22.5	22.3
Other Income	1,323	1,735	1,632	1,635
Depreciation	5,181	6,158	6,774	7,316
Impairment on Goodwill & Intangibles	1,353	688	-	-
EBIT	19,100	20,716	24,668	27,561
Interest	1,056	914	972	905
Profit Before Tax	18,044	19,801	23,696	26,656
Tax	5,035	4,059	5,213	5,864
Exceptional gain/(loss)	-	-	785	-
Adj Net Profit	13,009	15,742	18,483	20,792
Reported Net Profit	13,009	15,742	19,268	20,792
NPM (%)	13.3	13.8	14.0	13.9

Key Ratios (Consolidated)

Y/E	FY12A	FY13E	FY14E	FY15E
EBITDA Margin (%)	25.8	22.6	22.5	22.3
EBIT Margin (%)	20.2	18.1	18.6	18.5
NPM (%)	13.3	13.8	14.0	13.9
ROCE (%)	28.4	25.5	25.2	23.8
ROE (%)	26.1	25.0	23.3	21.3
Adj EPS (₹)	76.7	92.7	108.8	122.4
P/E (x)	27.3	22.6	19.2	17.1
BVPS (₹)	294.2	370.2	467.3	573.5
P/BVPS (x)	7.1	5.6	4.5	3.6
EV/Operating Income (x)	13.9	12.6	10.8	9.4
EV/EBITDA (x)	14.6	13.5	11.3	9.9
EV/EBIT (x)	18.6	16.8	13.7	11.9

Valuation and view

DRL's revenue CAGR of 15% during FY12E-FY15E is likely to support a PAT CAGR of 17%. New product launches in the US and important launches over the medium term would provide impetus to the sales. In India, the company's leading brands continue to perform well (except Nise) and the biosimilars would emerge as key contributors to the future growth. Traction in Russia (on back of OTC portfolio) and PSAI (led by patent expiries and gain in new contracts) businesses are the further key growth drivers for DRL.

At a current market price (CMP) of ₹2,091, the stock trades at P/E of 19.2x FY14E and of 17.1x FY15E, earnings. We recommend 'BUY' with a target price of ₹2,325, arrived at 19x FY15E EPS which implies potential upside of 12.0% to the CMP from long term (1 year) perspective.



Indbank Merchant Banking Services Ltd.
I Floor, Khiviraj Complex I,
No.480, Anna Salai, Nandanam, Chennai 600035
Telephone No: 044 – 24313094 - 97
Fax No: 044 – 24313093
www.indbankonline.com

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