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Right ingredients in the growth mix

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Earnings below estimate: Dr Reddy's Laboratories' (DRL) Q4FY10 adjusted earnings (after adjusting for \$12 million of restructuring write-offs not in estimates) were below estimates, with net profit of Rs 1.9 billion versus our estimate of Rs 2.4 billion. The variance was primarily on the lower-than-expected sales, which were Rs 16.4 billion versus our estimate of Rs 18.4 billion and 5% lower QoQ, despite likely contribution from generic omeprazole over-the-counter drug during the quarter. Adjusted operating profits were Rs 2.7 billion versus our estimate of Rs 3 billion, with adjusted margins of 16.2% (vs 16.8%).

India and US to be key drivers in FY11: We maintain broad FY11/FY12 estimates both on the revenue front and at the earnings level. US business outlook in FY11 is crucial for DRL and we believe critical opportunities, including omeprazole OTC, generic Allegra 24 D (to be launched by end May 2010), and potential fondaparinux launch continue to remain key drivers with intact opportunities in FY11. We raise our estimates for domestic formulations, highlighting the almost 25% rise in the field force in FY10 and record new product introductions.

Outlook and valuations: We maintain our sum-of-the-parts (SOTP)-based value of Rs 1,200, valuing the base business (ex-exclusivities) at 17x FY12 EPS (earnings per share). We assign Rs 32 per share to one-off non-recurring opportunities, including generic omperazole OTC and Allegra 24D and fondaparinux. Management's reiteration of \$3 billion of sales by FY13 provides upside support to valuations, while the commencement of the GSK deal sales to Mexico is a positive. Potential balaglitazone licensing could also add upsides to estimates. However, valuations are at historical peaks, leaving little margin for execution risks. We maintain 'Hold' on the stock.

US, PSAI miss offset by higher India, Russia sales: Net revenues (ex-sumatriptan in Q4FY09) were flat (in Rs terms) and 10% lower than our estimate of Rs 18.4 billion. This miss was largely on account of US revenues, which recorded sales of Rs 3.5 billion versus our estimate of Rs 5 billion. While US sales increased sharply QoQ (19%), we note that Q3FY10 was unusually impacted by product recall issues in September 2009, which led to temporary slowdown in sales and loss of key customers. For FY10, DRL filed 12 ANDAs (abbreviated new drug applications—request for US generic drug approval) and launched eight products in FY10 and now has a pending pipeline of 73 products (of which 38 are PIVs (phase-IV trial stage) and 12 FTFs (first-to-file)). PSAI (pharmaceutical services & active ingredients) sales were flat in Q4FY10 (in Re terms) impacted by lower order offtakes and order postponement by key customers. For the full year FY10, PSAI at \$430 million business grew 9% in Re terms 6% in \$ terms.

Offsetting these misses were the domestic formulations and CIS businesses. Domestic business grew a healthy 26% YoY during the quarter and 20% for FY10. Robust new product introductions and geographical expansion should help the company sustain domestic formulation growth above industry in the medium term.

Investment theme: DRL's base business is expected to grow at 11% CAGR (compound annual growth rate) in FY10-12, on the back of branded formulations sales CAGR of 17%. Domestic formulation growth is expected to post 18% CAGR, while Russian operations are expected to post 17% CAGR in FY10-12. US revenues are expected to grow at 8% CAGR to Rs 21 billion in FY12 and will benefit from "one-off" opportunities in omeprazole OTC, fondaparinux and Allegra 24D.