



Dr.Reddy's Laboratories Ltd. (CMP: Rs.981)

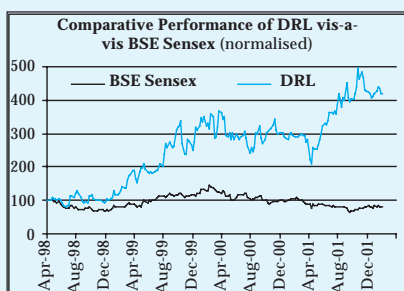
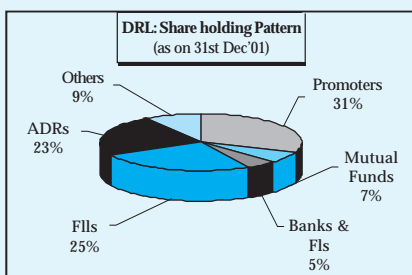
Short term : Under Performer
Long term : Out Performer

Stock Statistics

Market Cap (Rs. cr)	: 7511
52 week high (Rs.)	: 1150
52 week low (Rs.)	: 432
Avg. daily Volume	: 200,000 shares
Avg. daily trades	: 5000
Face Value (Rs.)	: 5
BSE Sensex	: 3633.93
BSE Code	: 500124
Reuters Code	: REDY.BO
Bloomberg Code	: DRRD@IN
Industry	: Pharmaceuticals

Investment Highlights

- DRL's future growth strategy hinges on its exports performance, which in turn depends on its generics business. Company plans to have a portfolio of 40 to 50 ANDAs by 2005 from the existing 19.
- No major upsides coming from the generics business in FY03. Ciprofloxacin and Omeprazole would lead the growth in FY04.
- FY05 & FY06 would be decisive years for the company when it expects to get six months exclusivity on Olanzapine 20 mg and Ondansetron 4, 8 & 24mg.
- International formulation sales is the most profitable business of the company. It is expected to grow by 67% in FY02. We expect the growth rate to come down to 25% in FY03 and to grow at a CAGR of 20% in FY04 and FY05.
- The success of DRF 2725 is very crucial for DRL. Its failure will have a negative impact on stock price and vice versa.
- We expect DRL's Net sales and Net profit to decline by 3% & 25% respectively in FY03. Between FY04 to FY06 we expect earnings to grow at a CAGR of 31%.
- At current price the stock trades at 17x FY02 earnings and 22x FY03 earnings. The Median PE and EV/EBIDTA since 1998 is 25x & 18x respectively. Based on PE multiple of 25x and E/EBIDTA of 15x, our one year price target is Rs.1100 and three year price target is Rs.1950.
- We expect the stock to be an Under performer in the short term. In the long term it will be an Out Performer.



Year	N. Sales (Rs. cr)	Net Profit (Rs. cr)	Chg (%)	EPS (Rs.)	PE (x)	ROE (%)	ROCE (%)
FY00	437.9	60.4	17	11.4	51	16	16
FY01	912.8	144.5	139	22.9	29	34	35
FY02 F	1487.8	446.9	209	58.4	17	50	49
FY03 F	1439.2	335.4	-25	43.8	22	23	24
FY04 F	1672.6	399.9	19	52.3	19	22	24

Sales:

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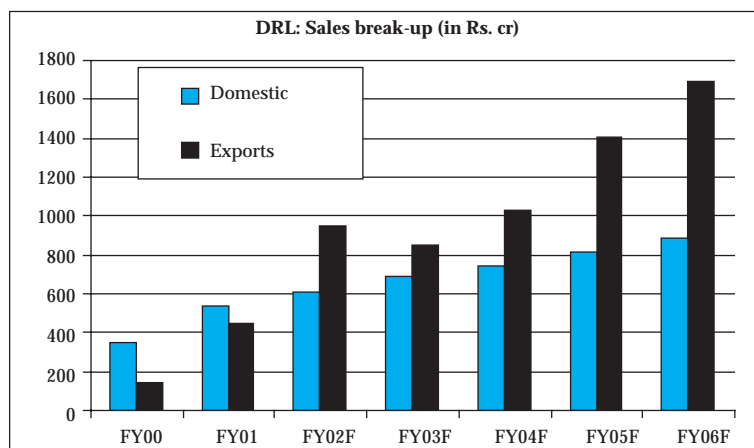


Exports as % of sales

FY00	: 29%
FY01	: 46%
FY02 F	: 61%
FY03 F	: 55%
FY04 F	: 58%
FY05 F	: 63%
FY06 F	: 66%

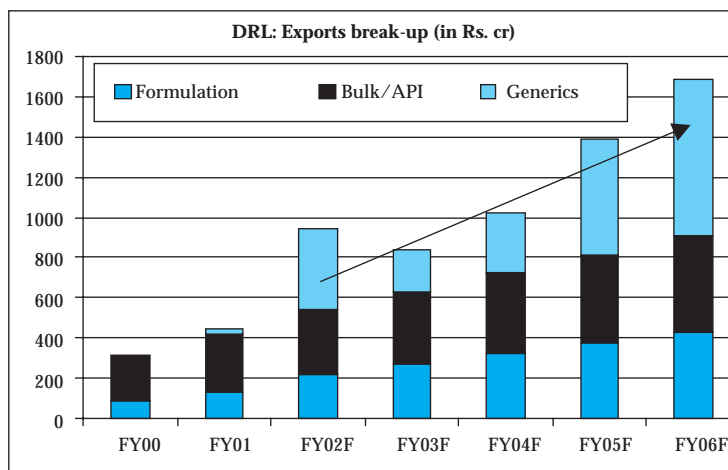
We are initiating coverage on Dr.Reddy's Laboratories Ltd. (DRL) with an under performer recommendation for the short term and with an Out performer recommendation for the long term. According to us the expected dip in earnings in FY03 will be the main reason for the stock to be an under performer in the short term. Nevertheless looking at the growth thereafter and other triggers such as acquisition, licensing opportunities, milestone payments and ANDA approvals we expect the stock to outperform in the long term (above one year)

In the last two years the company's sales mix has changed completely. Exports, which accounted for 29% of FY00 sales is expected to account for 61% of the company's sales in FY02. Contribution of exports is expected to fall in FY03 & FY04 and to rise thereafter in FY05 & FY06.



Generics: changing the company's business mix

The company's future growth strategy hinges on its exports performance. Exports should rise by 113% in FY02 due to Fluoxetine, but thereafter we expect a de-growth of 11% in FY03. FY05 & FY06 would be decisive years for the company when it expects to get six months exclusivity on Olanzapine 20 mg and Ondansetron 4, 8 & 24 mg.



DRL plans to file around 10 ANDAs per year out of which 3 to 4 would be under Para IV.

The company is very aggressive in challenging patents and filing Abbreviated New Drug Applications (ANDAs) in the US market. It expects to have a portfolio of 40 to 50 ANDAs by 2005 from the existing 19. DRL plans to file around 10 ANDAs per year out of which 3 to 4 would be under Para IV. The company will be meeting its target of filing 10 ANDAs set by it for FY02. By the end of CY02 the company should have 6 ANDAs under Para IV. (read about Para IV: Pg 15)



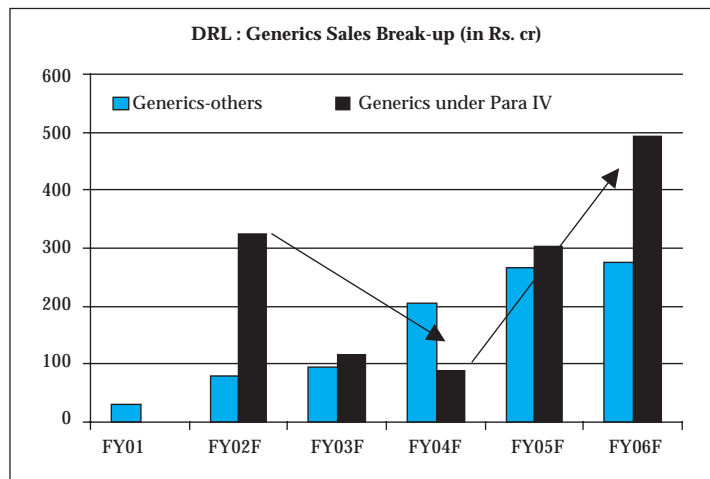
With 50% probability attached, combined cashflows from Olanzapine and Ondansetron in the six months exclusivity period could be around Rs.3 bn.

We expect Fluoxetine 40 mg sales to be in the range of US\$ 23 mn in FY03.

Omeprazole offers big opportunity even after exclusivity period.

At present the company is marketing its products through associates but is preparing to go on its own in 2003. If the company is able to build its own network by FY04 then that would help the company save substantial amount which otherwise would go to the associate partners.

The company claims to be the first to file in case of Olanzapine and Ondansetron. We assume Olanzapine would be launched at the start of FY05 and Ondansetron at the start of FY06. Being conservative we have assigned 50% probability to the cash flows likely to be generated by these two drugs in their six months exclusivity period. Out of the two even if one fails and the other goes through then earnings disappointment would be taken care of.



Patent challenging is a complex and long drawn process. The company has learned its lessons from the two drugs, Fluoxetine and Omeprazole. In case of Fluoxetine it has completed the six months of exclusivity. This experience would be very useful for the company as it will be able to leverage on its experience in managing its future launches. The failure in getting the six months exclusivity on Omeprazole brings forth the risks attached with the generic business.

We feel DRL has gained much insight about the working of US generics market. This sets up the platform for it to move ahead faster than other Indian companies in the US market.

Fluoxetine : Outlook after expiry of exclusivity.

The company's six months exclusivity on Fluoxetine 40 mg ended on 29th January 2002. Teva is the only competitor of the DRL in the 40 mg segment so price erosion would be minimal. In FY03 we have assumed DRL to have a 33% market share and price of generic version to be at a discount of 80% to the branded drug price. We expect Fluoxetine 40 mg sales to drop to US\$ 23mn in FY03 from US\$ 66 mn expected in FY02.

Omeprazole: Offers good opportunity

Omeprazole offers decent opportunity to DRL even after losing the six months exclusivity for 40 mg capsules. The company is planning to sell all the three dosages (10, 20 & 40 mg) after the six months exclusivity period that would be granted to Andrx. We have accounted for revenues from Omeprazole in FY04 by which we feel Andrx might have completed its six months exclusivity. To be on the safer side we have attached a 75% probability to the possible revenues that is likely to come from Omeprazole sales in FY04.



Company claims it is first to file in case of Olanzapine 20 mg tablets.

Overall revenues from Olanzapine in FY05 should be around Rs.227 cr. (with 50% probability attached during the six months exclusivity)

The launch of 5, 10 & 15 mg tablets of Olanzapine will help sustain growth after the six months exclusivity of 20 mg.

Ciprofloxacin: not so appealing

The company believes to be the first to file in case of Ciprofloxacin 100 mg and there is a possibility of getting a rolling exclusivity in case of 750mg. The market size of 100mg and 750 mg put together is around US\$ 65-70 mn. Attaching a 50% probability we expect revenues from Ciprofloxacin 100 mg to be around Rs.13 cr in the six months of exclusivity period. The launch of other dosages (250, 500 & 750 mg) would restrict the fall likely to come in after the completion of six months exclusivity of 100 mg. Competition would be very stiff after the exclusivity period and prices would fall sharply. Hence, we do not find the market for Ciprofloxacin so attractive.

About Olanzapine

Olanzapine is the generic version of Eli Lilly's anti-depressant drug 'Zyprexa'. The main patent on Olanzapine expires in 2011, but DRL can launch the drug in early 2004 if its patent challenge is successful. Zyprexa has a market of US\$ 1.9 bn in the US. There are four strengths of the drug, 5, 10, 15 & 20mg. The 10mg dosage accounts for the maximum sales of around US\$ 1 bn while the 15mg and 20mg account for about US\$ 100 mn. The 20mg has been recently launched and so its share is negligible but it is growing at a very fast pace.

DRL has filed ANDAs for all the dosages (5, 10, 15 & 20 mg) and claims to be the first to file in case of 20 mg tablets. By the time DRL launches its generic version the 20mg dosage should account for around US\$ 260 mn.

Valuation of Generic: Olanzapine

(US\$ mn)	FY05 (6 mths)	FY05 (6 mths)	FY06 (12 mths)	FY07 (12 mths)	FY08 (12 mths)
Market size of 20 mg	130				
Price discount to branded drug	50%	80%	85%	90%	90%
Market size after entry of Generic cos.	69	30	50	37	42
Market share of Generic cos. (Market share)	44	25	42	32	35
DRL's sales of 20 mg	44	8	8	5	4
DRL's market share	100%	30%	20%	15%	10%
Rupee rate	52.2	52.2	53.3	54.3	55.4
DRL's sales of 20 mg (in Rs.cr)	232	40	45	26	20
Probability	0.5	1.0	1.0	1.0	1.0
DRL's sales of 20 mg (in Rs.cr)	116	40	45	26	20
Operating profit	93	20	20	10	7
OPM (%)	80%	50%	45%	40%	37%
Market size of 5, 10 & 15 mg		227	381	253	284
DRL's market share		6%	6%	6%	6%
DRL's sales of 5, 10 & 15 mg		14	23	15	17
Rupee rate		52.2	53.3	54.3	55.4
DRL's sales of 5, 10 & 15 mg (in Rs.cr)		71	122	83	94
Operating profit		32	49	33	35
OPM (%)		45%	40%	40%	37%
Total Sales of 5, 10, 15 & 20 mg (in Rs.cr)	116	111	167	108	114
Total operating profit	93	52	69	43	42
OPM (%)	80%	47%	41%	40%	37%

Source: Company and KSBL estimates

About Ondansetron

Ondansetron is the generic version of GlaxoSmithKilne's anti-emetic drug 'Zofran'. DRL believes it is first to file for all the three dosages of 4mg, 8mg & 24mg. Zofran is used to prevent nausea and vomiting associated with chemotherapy and radiotherapy for cancer. Zofran's annualised sales in the US is around US\$ 550 mn out which tablets account for around US\$ 250 mn and the rest is accounted by injectibles. Hence the target market for DRL is around US\$ 250 mn.



Ondansetron is the first ANDA where the company claims to be the first to file on all dosages (4, 8 & 24 mg).

Domestic formulation sales should account for around 26% of company's total sales in FY02.

Zofran: Break-up of tablets sales (in US)

4 mg	approx. US\$ 60 mn
8 mg	approx. US\$ 190 mn
24 mg	approx. US\$ 10 mn

Note: 24 mg tablets were recently launched.

Ondansetron is the first ANDA where the company is believed to be the first to file for all the dosages. This gives the company a big opportunity to capitalize and maximize earnings during the 180 day exclusivity. The company plans to launch the product in 2004/2005. Since Glaxo also expects its Patent to expire in 2005, we have accounted for revenues in FY06. We have attached 50% probability for revenues likely to be generated in the 180 day exclusivity period.

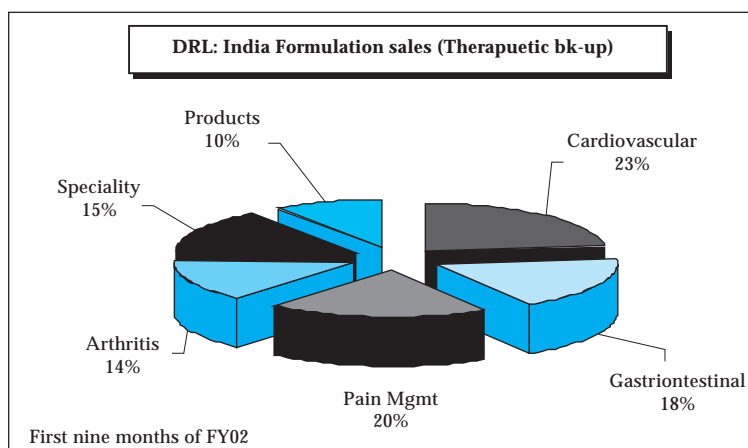
Valuation of Generic: Ondansetron

(US\$ mn)	FY06 (6 mths)	FY06 (6 mths)	FY07 (12 mths)	FY08 (12 mths)	FY09 (12 mths)
Market size of 4, 8 & 24 mg	225				
Price discount to branded drug	50%	80%	85%	90%	90%
Market size after entry of Generic cos.	120	52	87	65	71
Market share of Generic cos. (Market share)	77 64%	42 81%	72 83%	53 83%	60 85%
DRL's sales of 4, 8 & 24 mg	77	13	18	11	9
DRL's market share	100%	30%	25%	20%	15%
Rupee rate	52.2	52.2	53.3	54.3	55.4
DRL's sales (in Rs.cr)	402	66	96	58	50
Probability	0.5	1.0	1.0	1.0	1.0
DRL's sales (in Rs.cr)	201	66	96	58	50
Operating profit	161	33	43	23	19
OPM (%)	80%	50%	45%	40%	37%

Source: Company and KSBL estimates

Formulations: Domestic

DRL stands 7th in the Indian formulations market as per ORG Dec'01 with a market share of 2.6%. Three segments, Cardiovascular, pain management and gastrointestinals account for 62% of its formulation sales in India.



After the merger of American Remedies with itself the company has divided its field force into four groups with each group focussing on specific therapeutic segment. The results of the restructuring will be reflected in FY03 performance as the divisions were formed only in the second quarter of FY02.



Contribution of domestic formulation sales to overall sales will rise in FY03 and FY04 but thereafter it should consolidate at 25% of sales every year.

We expect company's domestic formulation sales to grow at a CAGR of 11% till FY05.

Divisionalisation into four groups:

Xenura	Recura	Aqura	Natura
Cardiac	Gastriointestinal	Omez	Neutraceuticals
Diabetes	Obstetrics	Nise	Natural products
Neuro Surgery	Ciprolet	Dermatology	
	Urology		

The company's existing focus is on cardiovascular, Gastrointestinal, Neutraceuticals and women's healthcare. Its new focus areas include, dermatology, CNS and Dental care. It has already acquired 6 dental brands from Group Pharmaceuticals with annual sales of Rs.16 cr. In future we could see some acquisition of brands in the dermatology segment.

Company's top 10 brands as on Dec'01 contribute 53% of total formulation sales in India.

Brand (Rs.cr)	Thereupetic	9 mths-FY01	9 mths-FY02	Change
Nise	Pain Mgmt	33.2	44.0	32%
Omez	Gastro-intestinal	32.0	34.7	8%
Stamlo	Cardiovascular	16.8	17.8	6%
Ciprolet	Anti-infectives	22.3	17.6	-21%
Enam	Cardiovascular	10.7	10.6	-1%
Antoxid	Anti Oxidants	7.2	8.6	18%
Stamlo Beta	Cardiovascular	7.6	9.2	20%
Bio-E 400 IU	Other Pain Vit.	7.1	7.2	2%
Reclide	Anti-diabetic	6.6	6.5	-1%
GLA-120/Clamp	Anti-infectives	4.5	6.2	38%
% of sales		55%	54%	

Source: Company

The company's existing focus is on cardiovascular, Gastrointestinal, Neutraceuticals and women's healthcare. Its new focus areas include, dermatology, CNS and Dental care. It has already acquired 6 dental brands from Group Pharmaceuticals with annual sales of Rs.16 cr. In future we could see some acquisition of brands in the dermatology segment.

Company's top 10 brands as on Dec'01 contribute 53% of total formulation sales in India.

Formulations: International

International formulation sales is the most profitable business of the company. We have done some fair calculations to check the profitability of this business.

Formulation sales of DRL in the first 9 months of FY02 (Rs.cr)

	As per Sales bk-up (Rs.cr)		As per segment wise bk-up (Rs.cr)	
		% of total		% of total #
Domestic	300.2	66.6	313.2	66.6
International	150.3	33.4	157.1	33.4
Total	450.5	100.0	470.3	100.0

assumed ratio between domestic and international sales.

Total formulation sales as given under sales break-up by the company is Rs.450 cr and that under segment wise revenue break-up is Rs.470 cr. The Sales break-up (domestic and international sales) is not given under segment wise reporting. So, we have assumed the ratio of domestic & international sales given by the company and applied the same to the total income reported under segment wise break-up.

We have assumed 25% EBIT margin in case of domestic formulation and worked out the EBIT margin from international formulation sales.



Russia accounted for 64% of DRL's international formulation sales in the first nine months of FY02.

We expect international formulation sales to grow by 67% in FY02, 25% in FY03 and at a CAGR of 20% thereafter till FY05.

Till date company has filed for 26 DMFs and plans to file 6 per year keeping in mind the US generics market

As given under segment wise break-up by the company

(Rs.cr)

EBIT (from total formulation sales)	A	173.0
Assuming EBIT margin of 25% from domestic formulations	B	78.3
Hence EBIT from International formulations	(A-B)	94.7
Hence EBIT margin from International formulations		60%

In international formulations the company is focusing on Russia, China and Brazil. Russia has been the main growth driver of international formulation sales in the first nine months of FY02. Russia accounted for 64% of the company's international formulation sales in the first nine months of FY02. Sales in Russian market grew by 167% in the first nine months of FY02.

International formulation sales: country wise break-up (in Rs.cr)

Country	9 mths-FY01	9 mths-FY02	Change
Russia	36.2	96.6	167%
Venezuela	4.2	6.8	62%
Ukraine	4.7	7.8	66%
Kazakhstan	4.2	7.1	69%
Vietnam	4.6	4.6	0%
Others	27.0	27.2	1%

The company has initiated a brand building exercise in the Russian market. It is also increasing its distribution and marketing network in that country. Seven regional managers and sixty two marketing representatives have been appointed in Russia.

China is another major market the company is exploring. Its joint venture Kunshan Rotam Reddy Pharmaceuticals has five products in the market and has applied for 6 more product registrations. China is a US\$ 8 bn market that can help sustain DRL's formulation sales in future. The Chinese market is very cost competitive therefore DRL is having an integrated approach to enter that market. The JV has set up a GMP compliant plant in China with investment of US\$5.6 mn.

Brazil is another market where the company wants to focus on. Till now DRL has failed in Brazil because it focused on branded generics whereas the government over there is promoting generics. DRL is restructuring its operations in Brazil by concentrating on the generics and bio-generics market over there.

This fiscal, international formulation sales of the company is expected to grow by 67% to around Rs.216 cr (FY01: Rs.130 cr). The entire growth will mainly be led by Russia. We do not expect this growth rates to sustain in future. As the base is already set very high this year we expect international formulation sales to grow by 25% in FY03 and at a CAGR of 20% between FY04 to FY05. Contribution of international formulation sales to the overall sales of the company should increase from 13% in FY01 to around 17% in FY05. The higher margins of this business will help sustain overall operating margins of the company in the long run.

Bulk Drugs/APIs: Exports holds the key

DRL has six bulk active plants and all of them have US FDA approvals. The bulk active business gives the company the advantage of managing its costs of formulations. This business accounted for 44% of the company's total gross sales in FY01. In FY02 it is expected to contribute around 32% of gross sales. Exports account for around 66% of the total bulk active sales.

DRL has a strategy of supplying bulk actives to the top US generic companies apart from using it for their own generics. For this it is aggressively filing DMFs in the regulated markets. Till date the company has filed for 26 DMFS. It plans to file for 6 DMFs per year keeping in mind the US generics business. DRL's future focus would be to shift from the rest of the world to the US & European markets. Future growth of the company would be mainly coming from international markets than from the domestic market.



DRF has a product pipeline of nine NCEs of which it has licensed three.

Novo Nordisk is continuing Phase III of DRF 2725 on its own...

...that instills some level of confidence on the success of DRF 2725.

We expect the company's bulk actives business to grow at a CAGR of 10% between FY03 to FY05. The contribution of bulk actives to the total turnover should remain above 30% till FY04. Higher thrust on exports should help maintain operating margins in this business to a certain extent.

Research & Development

Within a span of 10 years DRL has become a name to reckon with in Research & development. Many of its molecules are undergoing clinical trials, which may be future revenue earners for it. Dr.Reddy's Research Foundation (DRF), the research arm of DRL focuses on New Chemical Entities (NCEs) in the field of diabetes, oncology and pain management. Till date DRF has a product pipeline of nine NCEs of which it has licensed three molecules.

Molecule	Description	Status
DRF 2725	Anti-diabetic	Licensed to Novo Nordisk. (Phase III)
DRF 2593	Anti-diabetic	Licensed to Novo Nordisk. (Phase II)
DRF 4158	Metabolic disorders	Licensed to Novartis (Preclinical)
DRF 1042	Anti Cancer	Phase I, Undergoing trials in India
DRF 1644	Anti Cancer	Pre clinical completed. Clinical development in Europe.
DRF 4832	HDL Elevator	Late Preclinical. Contracted to Simbec, UK for clinical development.
DRF 3188	Anti Cancer, Viral infection	Late Preclinical.
DRF 4848	Anti Inflammatory (Cox II)	Late Preclinical. Licensing opportunity.
DRF NPPC	Non PPAR Insulin Sensitizer	Preclinical completed. Licensing opportunity.

Source: Company reports

DRF 2725 : the key to success

DRF 2725 is one of the key molecules the company has licensed to Novo Nordisk. In October 2001, Novartis, which had collaborated with Novo Nordisk to commercialise DRF 2725 discontinued its collaboration with the later. Even though Novartis ended its collaboration with Novo Nordisk the later has opted to go ahead and is conducting clinical in Phase III trails on its own.

GlaxoSmithKline, which was also working on a similar kind of drug for type 2 diabetes has discontinued development after reaching phase II clinical trials. This and the backing out of Novartis have raised many questions on the likely success of DRF 2725. According to Novo Nordisk, DRF 2725 is chemically different than the drug of GlaxoSmithKline and had shown greater lipid-lowering properties for given dosages in pre-clinical trials. The continuity of Phase III clinical trials by Novo Nordisk speaks of the confidence the company has in the product.

DRF 2725 acts as a dual sensitizer. It not only lowers blood sugar in the body but also improves the lipid/cholesterol profile. Novo Nordisk would be spending huge sum on Clinical Phase III of DRF 2725. This also instills some level of confidence about the success of the molecule. There are two competing molecules to DRF 2725, one from Merck and the other from AstraZeneca. Both these molecules are understood to be around one year behind in clinical developments as compared to DRF 2725.

If all goes well, this molecule can be commercialized and sold to diabetes and cholesterol patients by 2005. This molecule has been licensed to Novo Nordisk for US\$ 18 mn in milestone payment, manufacturing rights for global requirement and royalty payments. Till date DRL has received US\$ 10.25 mn from Novo Nordisk for DRF 2725.



DRF 4158, licensed to Novartis might enter Phase I by the end of this calendar year...

...If so, it would trigger another milestone payment for DRL.

The success or failure of DRF 2725 will have an impact on the other molecules undergoing clinical trials.

We feel Novo Nordisk has invested huge amount and time on DRF 2725 and so would continue Clinical Phase III on its own till it is able to find another buyer for the molecule.

DRF 4158: Licensed to Novartis

DRL has licensed DRF 4158 to Novartis for US\$ 55 mn in upfront & milestone payments and royalties. The molecule aims to treat type 2 (or non-insulin dependent) diabetes, diabetic dislipidemia, high blood pressure and obesity. The company has already received US\$5 in upfront payment from Novartis in Q2-FY02. Novartis is conducting toxicology studies and most probably DRF 4158 should enter phase I by the end of this calendar year. This would trigger another milestone payment for DRL.

In 1999 DRL set-up a research subsidiary Reddy Therapeutics in Atlanta, USA. Recently, this company discovered a novel molecular target, which is responsible for the three leading causes of restenosis. In addition to the target Reddy Therapeutics has also discovered a molecule that can act on the target. DRF set-up many years ago is now giving the desired outputs for the company. We hope investments in Reddy Therapeutics will also bare fruits in the coming years that will improve DRL's valuations.

Till date DRF has filed for over 65 patents. The company plans to spend 6% of its Sales on R&D in future. The management has decided to carry on clinical trials up to phase II on its own for all other molecules and then license them. This is line with its strategy of moving up the value chain in R&D.

Major Concerns

The major risk associated with the stock price is in relation to DRF 2725. We have not accounted for the net present value of the likely future cash flows that may come in from DRF 2725, in case the product is commercialized. Although we have not factored in any cash flows from DRF 2725, there could be a severe impact on the stock price, in case the molecule does not pass through the Phase III trials. The success or failure of DRF 2725 will have its impact on DRL's all the other molecules undergoing clinical trials.

The Patent challenging process is a high risk high return proposition in the US market. The US regulatory measures is a major external risk factor for the company's future generic business model. Timely new product approvals will be critical to the success of the generics business of the company and its valuation.

The company's business model is moving in the right direction giving it the cash flows required for R&D activity and acquisitions to sustain future growth. Between FY03 to FY05, DRL's formulation and bulk actives business should account for around 80% of the company's revenues. This reduces the risks attached with the generics business on the company.

Financials

Fluoxetine sales have changed the whole financial outlook of the company in FY02. In the first nine months of FY02 DRL's Net sales is up 71% to Rs.1093 cr and Net profit is up 251% to Rs.358 cr.

We expect the company to report Net Sales of Rs.1486 cr and Net profit of Rs.447 cr in FY02. Fluoxetine sales will lead to operating profit margins increasing from 26.7% in FY01 to 36.2% in FY02. The company has utilized the opportunity to write off Miscellaneous expenditure of Rs.108 cr against the stupendous rise in income in FY02. By doing so the company has saved its future profits to that extent.



Average ROCE & RONW will be around 26% & 24% respectively during FY03 to FY05.

At current price the stock trades at 17x FY02 earnings and 22x FY03 earnings.

DRL has retired all its outstanding debts in the mid of FY02 from the money raised through the ADR issue. The debt retirement and jump in operating profit will lead to increase in ROCE from 35% in FY01 to 50% in FY02. Its RONW is also expected to move up from 34% in FY01 to 49% in FY02. The company has made its intentions clear of acquiring generic companies in the Europe and the US. In our projections we haven't factored in the cost of acquisitions so to that extent we have assumed surplus funds to be parked in long term and liquid investment avenues.

The return ratios would go down substantially from FY03 onwards as we expect earnings to slide by 25% in FY03. We have assumed very miniscule returns on the surplus funds invested in financial instruments. The ROCE and RONW is expected to be in the range of 26% and 24% respectively in during the period FY03 to FY05.

We expect the company's Net Sales to decline by 3% in FY03 and to grow at a CAGR of 20% between FY04 to FY06. Operating margins would dip in FY03 & FY04 and should recover in FY05 & FY06. We expect the company's earnings to grow at a CAGR of 31% during FY04 to FY06.

DRL: Sales break-up

(Rs. cr)	FY01	FY02F	FY03F	FY04F	FY05F	FY06F
Total Gross Sales	984	1563	1586	1821	2298	2644
Bulk drugs / APIs	431	492	545	597	647	701
Domestic	143	168	188	197	207	217
International	288	325	357	400	440	484
Formulations	494	626	730	830	932	1040
Domestic	364	410	459	505	556	611
International	130	216	270	324	376	429
US Generics	30	81	95	204	266	275
Para IV	0	326	115	89	304	492
Others	29	41	47	54	61	69

Source: Company data & KSBL estimates

Sales expected from Para IV filings:

(Rs. cr)	FY02 F	FY03 F	FY04 F	FY05 F	FY06 F
Fluoxetine	326	115	63	54	40
Ciprofloxacin *			75	95	55
Olanzapine **				226	167
Ondansetron **					267
Total	326	115	89	304	492

* attached 75% probability to potential revenue of 100 mg in six months exclusivity.

** attached 50% probability to potential revenue in six months exclusivity.

Positive triggers for the stock in the next one year:

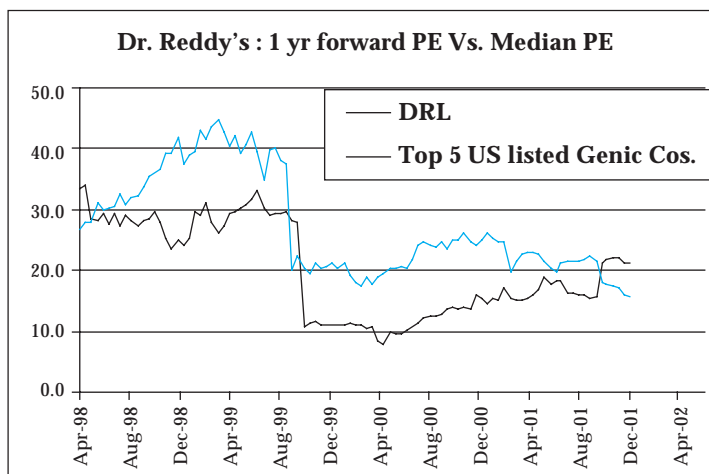
- Acquisitions. DRL plans to acquire a US & a European generics company.
- ANDA approvals and further filings of ANDAs under Para IV.
- Licensing of new molecules to MNCs.
- Possible milestone payment from Novartis on DRF4158 entering phase I.

Valuations

We have used two valuation parameters, PE multiple and EV/EBIDTA to derive at the fair value of the stock. At current market price of Rs.981 the stock trades at 17x FY02 earnings and 22x FY03 earnings. The median PE of the stock since 1998 till date has been 25x. We expect the stock to trade at its median PE of 25x in future also.

The correlation between DRL's PE multiple and the top 5 US listed generic companies was 0.8 between Apr'00 to Dec'01.

Since April 2000 The top three Indian Pharma companies have been following the price movements of the top 5 US listed Generic companies. Therefore it is imperative to study the valuations of the top US generic companies to ascertain the valuations DRL deserves. The target PE of the top five US listed generic companies for the next 12 months works to 28x. In line with this our assumption of DRL trading at its median PE of 25x seems to be justified.



On EV/EBIDTA basis the stock trades at 13x FY02 EBIDTA and 18x FY03 EBIDTA. The median EV/EBIDTA from FY98 till date has been 18x. To be on the conservative side we have assumed the ratio to be 15x to arrive the short term and long term potential price. Based on PE multiple of 25x and EV/EBIDTA of 15x we have arrived at the potential price in the short-medium term and long term. **Our one year price target works to Rs.1100 and our long term price for three years works to Rs.1950.**

Because of the expected dip in FY03 earnings and no short term triggers in the offing, except for an acquisition, we expect the stock to under perform in the short term (3 to 6 months). However, we remain bullish on the growth thereafter and so expect the stock to out perform in the long term.

Year (March)	Equity (Rs.cr)	PAT (Rs.cr)	EPS (in Rs.)	Avg.Price (in Rs.)	EBIDTA (Rs.cr)	EV (Rs.cr)	M.Cap (Rs.cr)	PE (x)	EV/EBIDTA (x)
FY98	26.5	49	9.2	147	67	789	779	16.0	11.8
FY99	26.5	52	9.8	249	77	1370	1319	25.5	17.8
FY00	26.5	60	11.4	584	91	3127	3092	51.3	34.2
FY01	31.6	145	22.9	654	244	4428	4134	28.6	18.2
FY02 F	38.2	447	58.5	981	538	7190	7495	16.8	13.4
FY03 F	38.2	335	43.9	981	368	6759	7495	22.3	18.4
FY04 F	38.2	400	52.3	981	438	6425	7495	18.7	14.7
FY05 F	38.2	596	78.1	981	631	5949	7495	12.6	9.4
FY06 F	38.2	762	99.7	981	778	5409	7495	9.8	7.0
Median (FY98 to FY02)								25	18

Price target:

Parameters	1 year	3 year
Based on PE (25x)	1212	2264
Based on EV/EDBIDTA (13x)	952	1617
Average of above	1082	1941

Note: We have not accounted for any upsides that can come from DRF 2725/4158 by way of milestone payments, manufacturing rights and royalty income. Commercialisation of any of the molecules will bring huge upsides to the future cash flows of the company.



Since last April the stock has appreciated by more than 100%.

Assigning 25% weightage to FY02 earnings and 75% weightage to FY03 earnings, the one year price target works to Rs.1212 (at 25x).

The stock does not sustain above 17x EV/EBIDTA.

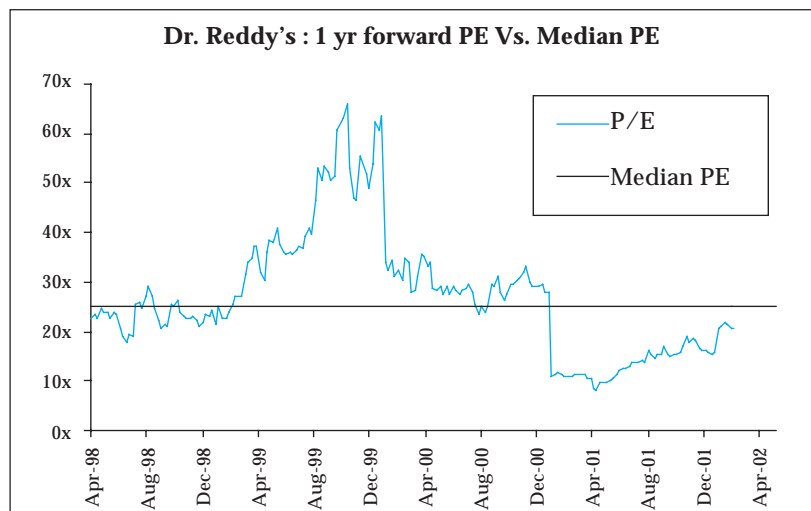
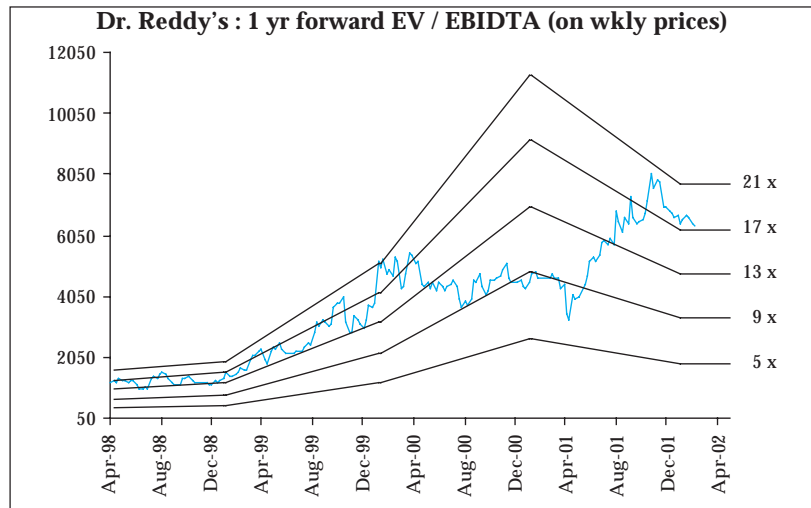
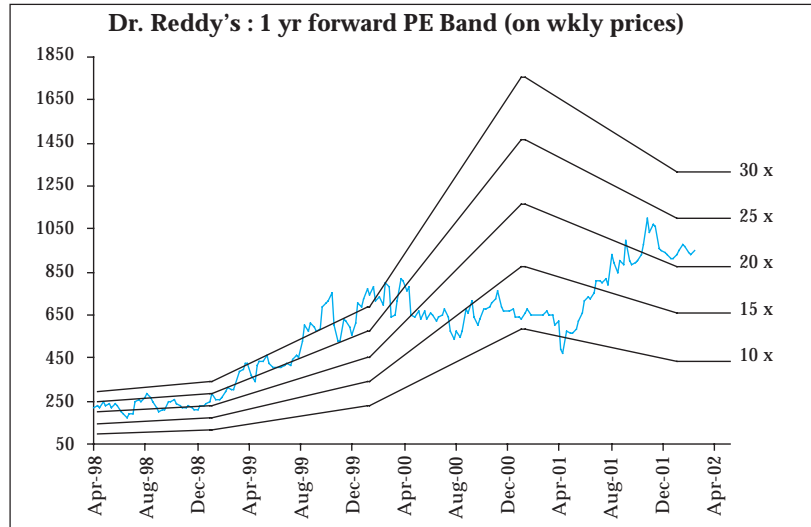
On EV/EBIDTA basis the stock appears to be costly at current price.

To determine potential price we have assumed EV/EBIDTA of 15x.

The stock does not sustain above 17x EV/EBIDTA.

On EV/EBIDTA basis the stock appears to be costly at current price.

To determine potential price we have assumed EV/EBIDTA of 15x.



Year end March (Rs. in cr)	Profit & Loss A/c						
	FY00	FY01	FY02 F	FY03 F	FY04 F	FY05 F	FY06 F
Net Sales	438	913	1486	1439	1673	2101	2458
% increase		108%	63%	-3%	16%	26%	17%
Raw Material Consumption	145	291	448	490	569	710	818
(as a % of Net Sales)	33.2	31.9	30.1	34.0	34.0	33.8	33.3
Other Mfg. Exp.	49	96	122	152	171	197	228
(as a % of Net Sales)	11.1	10.5	8.2	10.6	10.2	9.4	9.3
Personnel Expenses	37	76	99	119	139	159	179
(as a % of Net Sales)	8.4	8.4	6.7	8.3	8.3	7.6	7.3
Research & Development Exp.	13	42	87	97	110	123	137
(as a % of Net Sales)	3.0	4.6	5.8	6.8	6.6	5.8	5.6
Admin., Selling & other expenditure	103	164	193	214	246	280	319
(as a % of Net Sales)	23.4	17.9	13.0	14.9	14.7	13.3	13.0
Operating Profit	91	244	538	368	438	631	778
(as a % of Net Sales)	20.9	26.7	36.2	25.5	26.2	30.0	31.6
Interest expense	16	43	8	0	0	0	0
Gross Profit	75	201	530	368	438	631	777
(as a % of Net Sales)	17.1	22.0	35.7	25.5	26.2	30.0	31.6
Depreciation	13	43	51	62	70	77	84
Other Income	5	16	50	83	104	144	187
Extraordinary Income	0	1	39	0	0	0	0
Extraordinary Expenses	0	0	108	0	0	0	0
Profit Before Tax	67	176	460	388	472	698	881
Prov. for Tax (incl. Deferred tax)	7	31	13	52	72	102	119
Profit After Tax	60	144	447	335	400	596	762
(as a % of Net Sales)	13.8	15.8	30.1	23.3	23.9	28.4	31.0
Growth in Net Profit (%)		139%	209%	-25%	19%	49%	28%
Cash Profit	73	187	498	398	470	673	846
EPS (Rs.) - on face value of Rs.5	11.4	22.9	58.4	43.8	52.3	77.9	99.6
% increase		101%	155%	-25%	19%	49%	28%
Dividend & Dividend Tax	9	14	67	59	72	105	105
DPS (Rs.)	3.0	4.0	8.0	14.0	17.0	25.0	25.0
Book Value (Rs.)	11	15	22	32	43	59	820
Tax (%)	10	18	3	13	15	15	13
Dividend Payout (%)	15	10	15	18	18	18	14
Average Price (ex-split)	584	654	981	981	981	981	981
1 year forward P/E multiple *	51x	29x	17x	22x	19x	13x	10x

For FY2002 to FY2006 taken current market price as on 18th February 2002.

Balance Sheet							
Year end March (Rs. in cr)	FY00	FY01	FY02 F	FY03 F	FY04 F	FY05 F	FY06 F
Liabilities :							
Equity Share Capital	26	32	38	38	38	38	38
Preference Share Capital	0	0	0	0	0	0	0
Reserves & Surplus	355	427	1306	1592	1930	2431	3098
Long term debt	2	55	12	16	20	24	28
Short term debt	173	320	0	0	0	0	0
Total debt	175	375	12	16	20	24	27.7
Total Liabilities	556	834	1356	1646	1988	2493	3164
Assets :							
Gross Fixed Assets	223	485	540	595	650	710	785
Less : Accumulated Depn.	51	189	240	302	372	449	533
Net Fixed Assets	172	296	301	293	278	262	252.4
Capital Work in Progress	20	35	15	15	15	15	15
Investments	141	79	329	764	1102	1582	2126
Current Assets, Loans & Ad.							
Inventories	70	158	204	234	257	302	365
Sundry Debtors	128	285	366	439	467	528	638
Cash & Bank Balances	22	19	282	54	52	52	53
Loans, Adv. & O.Current Assets	72	97	69	72	75	78	81
Less Current Liab. & Prov.							
Sundry Creditors	45	98	123	145	164	198	237
Other Liabilities	11	12	11	11	11	11	11
Provisions	12	24	75	68	82	116	118
Net Current Assets	223	424	712	574	594	635	770.9
Total Assets	556	834	1356	1646	1988	2493	3164
RONW	16%	34%	50%	23%	22%	27%	27%
ROCE	16%	35%	49%	24%	24%	28%	27%
Total debt / equity ratio	0.5	0.8	0.0	0.0	0.0	0.0	0.0
Gross Block / Total capital employed	0.4	0.6	0.4	0.4	0.3	0.3	0.2
Debtors (as days sales)	105	112	89	110	100	91	93
Creditors (as days consumption)	111	121	99	107	104	100	104
Days inventory (as days cost of sales)	75	90	85	86	82	81	85
Enterprise Value :							
Market Value of equity	3094	4132	7507	7507	7507	7507	7507
Add : Debt	175	375	12	16	20	24	28
Less: Financial Assets	141	79	329	764	1102	1582	2126
Enterprise Value	3127	4428	7190	6759	6425	5949	5409
EV / EBIDTA	34x	18x	13x	18x	15x	9x	7x

Free Cash Flows (from operations)							
Year end March (Rs. in cr)	FY00	FY01	FY02 F	FY03 F	FY04 F	FY05 F	FY06 F
EBIT	83	219	467	388	472	699	881
Taxes on interest	2	8	0	0	0	0	0
Taxes on EBIT	5	23	13	52	72	102	119
NOPLAT (Net Op. profit less adj. tax)	78	196	455	335	400	597	762
Add: Depreciation	13	43	51	62	70	77	84
Gross Cash Flows	91	238	506	398	470	673	846
Less: Change in Working Capital	12	201	287	-137	19	42	136
Less: Capital expenditure	26	263	55	55	55	60	75
Free Cash Flows from operating activities	54	-225	163	480	396	572	636

DRL: Quarterly results

	9 mths FY01	9 mths FY02	% chg	Q4 FY01	Q4 FY02 E	% chg
Gross Sales	692.4	1151.0	66%	291.7	414.8	41%
Excise Duty	53.6	58.1	8%	17.7	21.2	20%
Net Sales	638.8	1092.9	71%	273.9	393.6	42%
Total Expenses	485.0	658.4	36%	184.6	290.1	55%
Operating Profit	153.8	434.4	182%	107.1	124.7	16%
Interest	32.3	6.8	-79%	8.0	0.4	-95%
Depreciation	30.1	35.9	19%	14.6	15.0	2%
Contract Research	0.0	0.5	0.0	0.0		
Other Income	23.7	37.6	59%	-6.2	12.0	-294%
Extra-ordinary Inc.	0.0	38.6	0.0	0.0		
Extra-ordinary Exp.	0.0	108.3	0.0	0.0		
PBT	115.1	360.0	213%	78.2	121.3	54%
Tax	13.0	32.5	150%	18.1	18.2	0%
Deferred Tax	0.0	-30.9	0.0	-7.0		
Net Profit	102.06	358.5	251%	60.2	103.1	71%
OPM (%)	22.2%	37.7%		36.7%	30.1%	
NPM (%)	14.7%	31.1%		20.6%	24.9%	

Abbreviations & Explanations

Generics drug: The active chemical ingredient that goes into any branded drug is the generic name of that drug. For example, Omeprazole (generic name) is the main chemical compound that goes into Prilosec (brand name). On expiry of the Patent, other pharmaceutical companies can manufacture and sell the drug on getting approval from the US FDA. Such a drug is sold under the generic name and is commonly referred as a generic.

ANDA: ANDA is the abbreviation of 'Abbreviated New Drug Application'. Whenever a company wants to sell a generic version of any branded drug in the US, then it has to file an ANDA. An ANDA contains all the details of the generic for which permission is being sought. A bio equivalency of the drug is then carried out to establish that it is the same as the patented drug. Along with the ANDA the generic company has to file a certificate (Para I to Para IV) on the patent situation of the drug of which the generic version is proposed.

DMF: It is the abbreviation of 'Drug Master File'. It is usually referred to the raw material or active ingredient that goes into the making of the bulk drug. For example If a generic company files an ANDA for Omeprazole with the US FDA, it would require a DMF for the bulk drug. A DMF is a list of information on plants, processes and ingredients used in drug manufacture.

Para IV certification: Pharmaceutical companies can also file an ANDA with the US FDA prior to the expiry of product patent. In such a case the filer has to file the ANDA under Para IV of the Hatch-Waxman Act. By filing Para IV, the generic company says that the existing patent is invalid or not infringed. A generic company filing a Para IV with the US FDA must also notify the patent holder. The patent holder gets 45 days to respond to the notice. Usually the patent holder files a law suit challenging the generic company.

Once the Patent holder challenges the generic company a time period of 30 months is given to both sides. During this 30 months period, the US FDA can grant the generic company 'approvable' status, pending the litigation outcome or the 30 month period. In case the litigation is not complete within the 30 months period then the FDA will review the approvable ANDA and if the generic meets FDA specifications, then it can be approved.

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