

Dr. Reddy's Laboratories

Performance Highlights

Y/E March (₹ cr)	2QFY2018	1QFY2018	% chg (qoq)	2QFY2017	% chg (yoy)
Net sales	3,546	3,316	6.9	3,586	(1.1)
Gross profit	2,170	1,990	9.1	2,278	(4.7)
Operating profit	649	306	112.3	579	12.1
Adj. net profit	285	59	382.1	295	(3.3)

Source: Company, Angel Research

Dr Reddy's Labs (DRL) posted poor results for 2QFY2018, which were much lower than expectations. The sales came in at ₹3,546cr (₹3,700cr expected) v/s. ₹3,586cr, a yoy de-growth of 1.1%. Global Generics at ₹2,862cr, posted a yoy de-growth of 1.0%, while PSAI at ₹119cr, registering a yoy de-growth of 2.0%. On operating front, the EBDITA came in at 18.3% (19.7% expected) v/s. 16.2% in 2QFY2017. R&D expenses were at 11.8% of sales in 2QFY2018 v/s. 14.5% of sales in 2QFY2017. Consequently, the PAT came in at ₹285cr (₹594cr expected) v/s. ₹295cr in 2QFY2017, a yoy de-growth of 3.3%. **We maintain our Reduce.**

A subdued quarter: The sales came in at ₹3,546cr (₹3,700cr expected) v/s. ₹3,586cr, a yoy de-growth of 1.1%. Global Generics at ₹2,862cr, posted a yoy de-growth of 1.0%, while PSAI at ₹119cr, registered a yoy de-growth of 2.0%. The Global Generics, which forms 81% of overall sales, saw dip in its key growth market USA (₹1,432cr), which posted a dip of 11.0% yoy, while Indian sales at ₹637cr posted a growth of 2.0%. The USA market continued to reel under the pricing pressures, while Indian sales were under the pressure on the back of GST. On operating front, the EBDITA came in at 18.3% (19.7% expected) v/s. 16.2% in 2QFY2017. R&D expenses were at 11.8% of sales in 2QFY2018 v/s. 14.5% of sales in 2QFY2017. Consequently, the PAT came in at ₹285cr (₹594cr expected) v/s. ₹295cr in 2QFY2017, a yoy de-growth of 3.3%.

Outlook & Valuation: We expect net sales to grow at a CAGR of 5.1% to ₹15,548cr and adjusted EPS to post a CAGR of 18.5% to end the period at ₹102 in FY2019E. **We recommend a Reduce.**

Key financials (IFRS Consolidated)

Y/E March (₹ cr)	FY2016	FY2017	FY2018E	FY2019E
Net sales	15,471	14,081	13,734	15,548
% chg	4.4	(9.0)	(2.5)	13.2
Net profit	2,001	1,204	1,158	1,691
% chg	(9.8)	(39.8)	(3.8)	46.0
Adj net profit	2,357	1,204	1,158	1,691
% chg	6.3	(48.9)	(3.8)	46.0
Adj. EPS (₹)	138.2	72.6	69.9	102.0
EBITDA margin (%)	24.6	16.1	17.7	20.2
P/E (x)	17.1	32.5	33.8	23.2
RoE (%)	19.7	9.6	9.2	12.4
RoCE (%)	18.7	7.5	7.7	10.3
P/BV (x)	3.1	3.2	3.0	2.7
EV/Sales (x)	2.6	3.0	3.1	2.7
EV/EBITDA (x)	10.4	18.5	17.4	13.6

Source: Company, Angel Research; Note: CMP as of November 22, 2017

REDUCE

CMP	₹2,361
Target Price	₹2,040
Investment Period	12 months

Stock Info

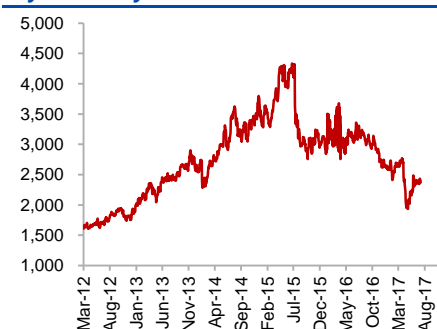
Sector	Pharmaceutical
Market Cap (₹ cr)	39,172
Net Debt (₹ cr)	2,839
Beta	0.4
52 Week High / Low	3,247/1902
Avg. Daily Volume	48,076
Face Value (₹)	5
BSE Sensex	33,562
Nifty	10,342
Reuters Code	REDY.BO
Bloomberg Code	DRRD@IN

Shareholding Pattern (%)

Promoters	26.8
MF / Banks / Indian FIs	17.2
FII / NRIs / OCBs	45.7
Indian Public / Others	10.4

Abs. (%)	3m	1yr	3yr
Sensex	6.3	29.3	17.8
Dr Reddy	16.4	(24.3)	(33.0)

3-year Daily Price Chart



Source: Company, Angel Research

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Exhibit 1: 2QFY2018 performance (IFRS, consolidated)

Y/E March (` cr)	2QFY2018	1QFY2018	% chg (qoq)	2QFY2017	% chg (yoy)	1HFY2018	1HFY2017	% chg
Net sales	3,546	3,316	6.9	3,586	(1.1)	6,862	6,714	2.2
Other income/(loss)	11	42	(72.5)	64		53	246	-
Total income	3,557	3,357	6.0	3,650	(2.5)	6,915	6,960	(0.6)
Gross profit	2,170	1,990	9.1	2,278	(4.7)	4,160	5,091	(18.3)
Gross margin (%)	61.2	60.0		63.5		60.6	75.8	
SG&A expenses	1,103	1,176	(6.2)	1,177	(6.3)	2,280	2,303	(1.0)
R&D expenses	418	508	(17.7)	521	(19.9)	925	1,917	(51.7)
EBDITA	649	306	112.3	579	12.1	955	871	9.7
EBDITA (%)	18.3	9.2	-	16.2	-	13.9	13.0	-
Depreciation	280	280	0.0	268.2	4.4	559.8	505.8	10.7
Interest	2	-	-	-	-	-	-	-
PBT	381	67	465.0	375	1.5	448	611	(26.7)
Tax	103	18	470.6	89	16.0	121	148	(18.4)
Net Profit	278	49	463.0	287	(3.0)	328	462	(29.1)
Share of profit/ (loss) in associates	9	10		8.0		19.2	-	
Reported net profit before exceptional	285	59	382.1	295	(3.3)	347	462	(25.0)
Exceptional items (loss) /profit	-	-	-	-	-	-	-	-
Reported PAT	285	59	382.1	295	(3.3)	347	462	(25.0)
Adj. Net Profit	285	59	382.1	295	(3.3)	347	462	(25.0)
EPS (`)	17.2	3.6		17.8		20.9	27.9	

Source: Company, Angel Research

Exhibit 2: Actual Vs Estimates

(` cr)	Actual	Estimates	Variation (%)
Net sales	3,546	3,700	(4.2)
Other income	11	64	(82.2)
Operating profit	649	731	(11.1)
Tax	103	191	(46.2)
Adj. Net profit	285	594	(52.0)

Source: Company, Angel Research

Revenue lower than expectations: The sales came in at `3,546cr (`3,700cr expected) v/s. `3,586cr, a yoy de-growth of 1.1%. Global Generics at `2,862cr, posted a yoy de-growth of 1.0%, while PSAI at `119cr, registered a yoy de-growth of 2.0%. The Global Generics, which forms 81% of overall sales, saw dip in its key growth market USA (`1,432cr), which posted a dip of 11.0% yoy, while Indian sales at `637cr posted a growth of 2.0%. The USA market continued to reel under the pricing pressures, while Indian sales were under the pressure on the back of GST.

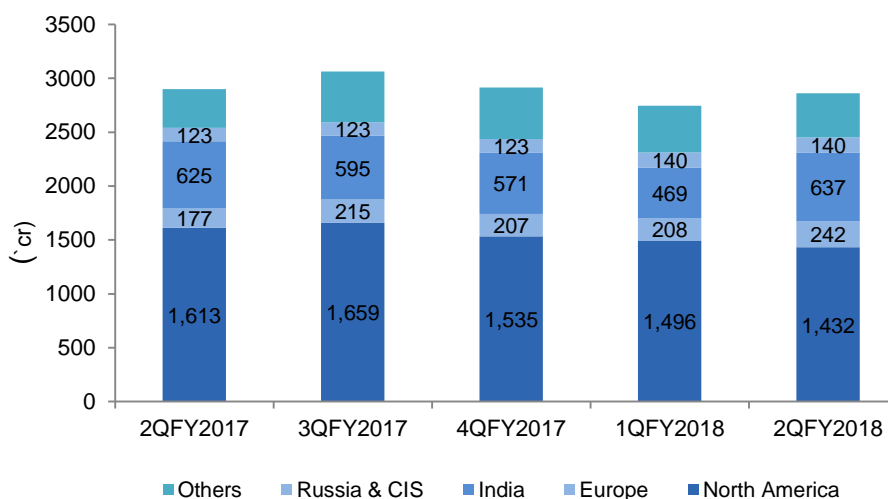
The global generic market had sales of `2,862cr (down 1.0% yoy). Europe posted a yoy growth of 36.0% to end the period at `242cr. Growth was driven by the new product launches and volume growth. Apart from this, the Emerging markets (`551cr, up 14% yoy) posted robust growth on the back of Russia (~`320cr), which posted a growth of 20% in the reported currency, while on constant currency terms the region posted a yoy growth of 13%. Its key growth market USA (`1,432cr), posted a dip of 11.0% yoy, while India (`637cr), posted a growth of 2.0%.

US posted a dip, primarily on account of higher price erosion, increased competition in the key products. This was partially offset by contribution from new launches. During the quarter, the company launched 4 new products.

The PSAI segment posted sales of `565cr, up 22.0% yoy. The growth came in on the back of Europe (`194cr, a yoy growth of 4%) and ROW (`232cr, a yoy growth of 35.0%). However, growth was registered in Indian market (sales of `44cr, a yoy growth of 51%) and USA (`96cr, a yoy growth of 23%).

As of September 30, 2017, cumulatively 103 generic filings are pending for approvals with the USFDA (100 ANDAs and 3 NDAs under 505(b)(2) route). Of these 100 ANDAs, 60 are Para IVs, out of which we believe 28 have 'First to File' status.

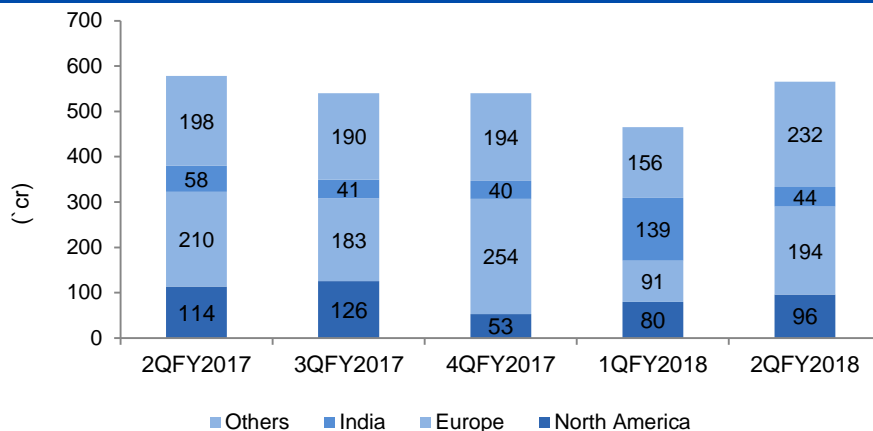
Exhibit 3: Trend in Global generics



Source: Company, Angel Research

In the PSAI segment (16% of sales), the US grew by 23% yoy, while, ROW, Europe and India grew by 35%, 4% & 51% yoy respectively during the quarter. Proprietary Products & Others at `119cr posted a yoy growth of 13.0%.

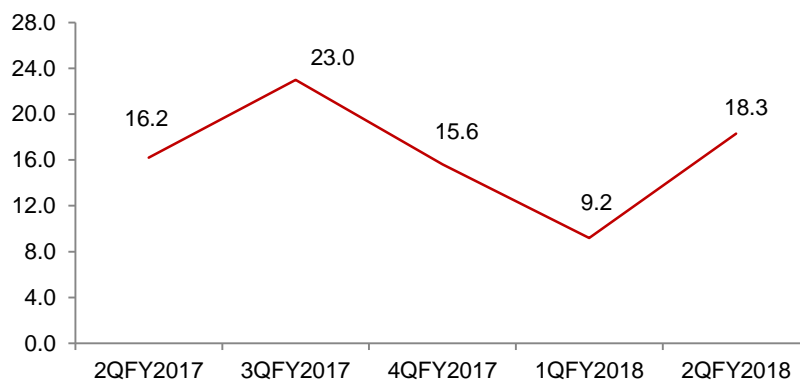
Exhibit 4: PSAI trend



Source: Company, Angel Research

EBITDA margin expands yoy: On operating front, the EBDITA came in at 18.3% (19.7% expected) in 2QFY2018 v/s. 16.2% in 2QFY2017. R&D expenses were at 11.8% of sales in 2QFY2018 v/s. 14.5% of sales in 2QFY2017. Gross margins during the quarter were at 61.2% v/s. 63.5% in 2QFY2017. In spite of the same, 6.3% and 19.9% dip in the employee cost and R&D expenses respectively aided the margin expansion.

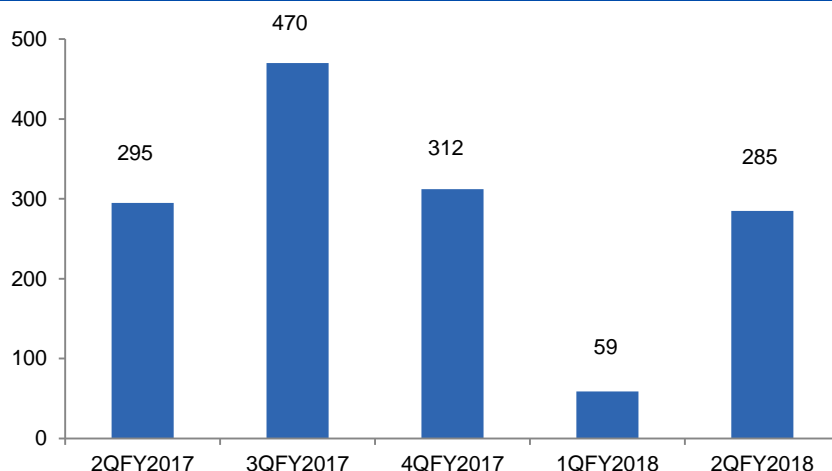
Exhibit 5: EBITDA margin trend (%)



Source: Company, Angel Research

Net profit lower than expected: Consequently, the PAT came in at `285cr (`594cr expected) in 2QFY2018 v/s. `295cr in 2QFY2017, a yoy de-growth of 3.3%. The net profit was lower than expected mainly on the back of the lower than expected OPM and other income.

Exhibit 6: Adjusted net profit trend



Source: Company, Angel Research

Concall takeaways

- Company guided for 2-3 new launches/quarter in USA.
- Duvvada USFDA re-inspection in 4QFY2018.
- DRL expects 15 ANDA launches in FY2018 (including 4-5 meaningful launches).
- Tax rate in FY2018 to stay at ~23-25% of PBT.
- 2nd Copaxone DMF filing will happen in two months (apart from Srikakulam facility).
- R&D expense is expected to remain at higher levels due to strong product pipeline of complex generics, Biosimilars and differentiated products. R&D expenses during the quarter are expected to be ~`2000cr in FY2018.

Investment arguments

Robust pipeline for US going ahead: After attaining a critical mass (US\$981mn in FY2017), DRL aims to scale up its business to the next orbit in the US market on the back of a strong product pipeline (103 ANDAs are pending approval, of which, 60 are Para IVs and 28 are FTFs). The Management has guided for a robust growth in the US over the medium term, driven by introduction of new products, some of which are also Para IV opportunities. Owing to the import alert on the three facilities of the company, we expect the ex-exclusivity US sales to be almost flat.

Domestic to be back in focus: DRL reported a 9.0% yoy growth in FY2017. The management expects the company's performance to rebound and targets to achieve an above industry growth rate going ahead, driven by –

(a) field force expansion and improvement in productivity; (b) new product launches (including biosimilars); and (c) focus on brand building. In 4QFY2015, DRL had acquired UCB's India portfolio and had completed the integration process of these brands in 1QFY2016. UCB's India business had registered ~`150cr sales in CY2014 and has a branded portfolio of 21 products focusing on Allergy, Respiratory, Dermatology and Pediatric space. The acquisition had been successfully integrated by 2QFY2016. Also, in FY2017, the domestic formulation business posted a lower growth, on account of NPPA pricing notifications and demonetization. In FY2018, the Indian domestic sales have taken a hit on the back of GST implementation, and hence, the year is expected to end with domestic formulation business growing at single digit or low double digit growth. Thus, we expect sales in India to post a CAGR of 8.9% over FY2017-19E.

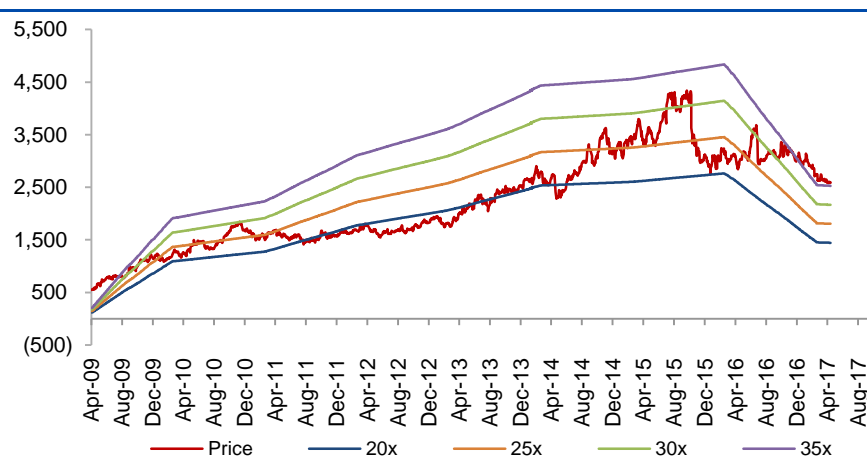
Outlook & Valuation: We expect net sales to grow at a CAGR of 5.1% to `15,548cr and adjusted EPS to post a CAGR of 18.5% over FY2017-19E to end FY2019 at `102. The stock has been severely beaten down post the import alert from the USFDA. However, considering the valuations, **we recommend a Reduce rating on the stock.**

Exhibit 7: Key assumptions

	FY2018E	FY2019E
PSAI segment growth (%)	3.5	3.8
Generics segment growth (%)	(4.3)	14.8
Operating margin (%)	17.7	20.2
Capex (` cr)	1200	1200

Source: Company, Angel Research

Exhibit 8: PE chart



Source: Company, Angel Research

Exhibit 9: Recommendation summary

Company	Reco.	CMP (₹)	Tgt Price (₹)	Upside (%)	FY2019E			FY17-19E	FY2019E	
					PE (x)	EV/Sales (x)	EV/EBITDA (x)	CAGR in EPS (%)	RoCE (%)	RoE (%)
Alembic Pharma	Buy	511	600	17.3	21.4	2.9	13.0	5.7	20.6	18.4
Aurobindo Pharma	Buy	699	823	17.8	13.6	2.5	9.9	14.2	25.3	22.7
Cadila Healthcare	Reduce	443	411	(7.2)	21.6	4.1	17.6	18.9	16.5	22.2
Cipla	Sell	619	462	(25.3)	25.5	3.2	16.2	39.3	10.9	13.1
Dr Reddy's	Reduce	2,361	2,040	(13.6)	23.2	3.1	13.3	18.5	10.3	12.4
Dishman Pharma	Under Review	301	-	-	19.3	2.7	10.1	23.3	4.5	4.4
GSK Pharma	Sell	2,496	2,000	(19.9)	53.9	6.9	39.3	19.3	25.8	23.5
Indoco Remedies	Sell	280	136	(49.0)	23.5	2.1	14.9	16.2	10.1	14.5
Ipca labs	Neutral	535	-	-	21.2	1.9	13.5	24.7	12.4	11.0
Lupin	Buy	828	1,091	31.8	16.7	2.4	9.3	(6.6)	13.7	13.7
Sanofi India*	Neutral	4,434	-	-	27.1	3.8	17.0	12.8	25.8	27.5
Sun Pharma	Buy	535	615	15.0	24.0	3.7	16.3	(17.5)	11.3	14.0

Source: Company, Angel Research; Note: *December year ending

Company Background

Established in 1984, Dr. Reddy's Laboratories is an integrated global pharmaceutical company, through its three businesses - Pharmaceutical Services & Active Ingredients, Global Generics and Proprietary Products. The company's key therapeutic focus is on gastro-intestinal, cardiovascular, diabetology, oncology, pain management, anti-infective and paediatrics. The company's key markets include India, USA, Russia & CIS and Germany.

Profit & loss statement (IFRS Consolidated)

Y/E March	FY2014	FY2015	FY2016	FY2017	FY2018E	FY2019E
Net sales	13,217	14,819	15,471	14,081	13,734	15,548
Other operating income	141.6	91.7	87.4	106.5	106.5	106.5
Total operating income	13,359	14,911	15,558	14,187	13,840	15,654
% chg	12.5	11.6	4.3	-8.8	-2.4	13.1
Total expenditure	10,096	11,535	11,669	11,811	11,308	12,411
Cost of revenues	4,977	5,531	5,315	5,219	5,402	5,725
SG&A expenses	3,878	4,259	4,570	4,637	3,983	4,509
R&D expenses	1,240	1,745	1,783	1,955	1,923	2,177
EBITDA	3,121	3,284	3,802	2,270	2,426	3,137
% chg	16.6	5.2	15.8	-40.3	6.9	29.3
(% of Net Sales)	23.6	22.2	24.6	16.1	17.7	20.2
Depreciation & amortisation	659.8	747.4	927.4	1,026.6	1,052.8	1,115.5
EBIT	2,462	2,537	2,875	1,243	1,373	2,021
% chg	27.4	3.1	13.3	-56.7	10.5	47.2
(% of Net Sales)	18.6	17.1	18.6	8.8	10.0	13.0
Interest & other charges	-	-	-	-	-	-
Other Income	40.0	168.2	(270.8)	80.6	80.6	80.6
(% of PBT)	1.5	6.0	(10.0)	5.5	5.1	3.6
Share in profit of associates	17.4	19.5	22.9	34.9	34.9	34.9
Recurring PBT	2,661	2,816	2,714	1,465	1,595	2,243
% chg	19.0	5.9	-3.6	-46.0	8.9	40.6
Extraordinary expense/(Inc.)	-	-	508.5	-	-	-
PBT (reported)	2,660.6	2,816.3	2,714.0	1,465.3	1,595.4	2,243.2
Tax	509.4	598.4	712.7	261.4	436.9	552.1
(% of PBT)	19.1	21.2	26.3	17.8	27.4	24.6
PAT (reported)	2,151.2	2,217.9	2,001.3	1,203.9	1,158.5	1,691.1
Add: Share of earnings of asso.	-	-	-	-	-	-
Less: Minority interest (MI)	-	-	-	-	-	-
Exceptional items	-	-	-	-	-	-
PAT after MI (reported)	2,151.2	2,217.9	2,001.3	1,203.9	1,158.5	1,691.1
ADJ. PAT	2,151.2	2,217.9	2,357.0	1,203.9	1,158.5	1,691.1
% chg	22.9	3.1	6.3	(48.9)	(3.8)	46.0
(% of Net Sales)	16.3	15.0	12.9	8.5	8.4	10.9
Basic EPS (₹)	126.7	130.2	138.2	72.6	69.9	102.0
Fully Diluted EPS (₹)	126.7	130.2	138.2	72.6	69.9	102.0
% chg	22.9	2.7	6.1	(47.4)	(3.8)	46.0

Balance sheet (IFRS Consolidated)

Y/E March (` cr)	FY2014	FY2015	FY2016	FY2017	FY2018E	FY2019E
SOURCES OF FUNDS						
Equity share capital	84.9	85.2	85.3	82.9	82.9	82.9
Preference Capital	-	-	-	-	-	-
Reserves & surplus	8,995	11,045	12,748	12,179	12,938	14,230
Shareholders' funds	9,080	11,130	12,834	12,262	13,021	14,313
Minority Interest						
Total loans	4,474.2	3,954.3	3,661.9	5,335.1	6,000.0	6,800.0
Deferred tax liability	(192.9)	(401.3)	(423.0)	(516.4)	(516.4)	(516.4)
Total liabilities	13,361	14,683	16,073	17,081	18,505	20,597
APPLICATION OF FUNDS						
Net fixed assets	3,945	4,314	5,396	5,142	6,342	7,542
Goodwill /other intangibles	1,470	1,643	1,969	4,618	4,618	4,618
Capital Work-in-Progress	495.2	495.2	495.2	495.2	495.2	495.2
Investments	2,589	3,811	3,833	2,110	2,110	2,110
Current Assets	7,866	8,558	8,465	8,257	8,216	9,605
Cash	845	539	492	387	791	1,206
Loans & Advances	793.0	889.1	928.2	844.9	824.0	932.9
Other	6,228	7,129	7,045	7,025	6,600	7,465
Current liabilities	3,006	4,214	4,193	4,057	3,792	4,289
Net Current Assets	4,860	4,344	4,273	4,199	4,423	5,315
Other Assets		76	106	517	517	517
Total Assets	13,361	14,683	16,073	17,081	18,505	20,597

Cash flow statement (IFRS Consolidated)

Y/E March (₹ cr)	FY2014	FY2015	FY2016	FY2017	FY2018E	FY2019E
Profit before tax	2,661	2,816	2,714	1,465	1,595	2,243
Depreciation	660	747	927	1,027	1,053	1,116
(Inc.)/Dec in Working Capital	(906)	211	24	(32)	181	(477)
Less: Other income	40	168	(271)	81	81	81
Direct taxes paid	509	598	713	261	437	552
Cash Flow from Operations	1,865	3,008	3,224	2,118	2,311	2,249
(Inc.)/Dec.in Fixed Assets	(164)	(369)	(1,082)	254	(1,200)	(1,200)
(Inc.)/Dec. in Investments	824	1,222	22	(1,723)	-	-
Other income	40	168	(271)	81	81	81
Cash Flow from Investing	701	1,021	(1,331)	(1,389)	(1,119)	(1,119)
Issue of Equity	-	0	0	(2)	-	-
Inc./Dec.) in loans	798	(520)	(292)	1,673	665	800
Dividend Paid (Incl. Tax)	358	399	399	399	399	399
Others	(3,390)	(4,214)	(2,047)	(2,904)	(1,851)	(1,914)
Cash Flow from Financing	(2,234)	(4,335)	(1,940)	(834)	(787)	(715)
Inc./Dec.) in Cash	331	(306)	(47)	(106)	405	415
Opening Cash balances	514	845	539	492	387	791
Closing Cash balances	845	539	492	387	791	1,206

Key ratios

Y/E March	FY2014	FY2015	FY2016	FY2017	FY2018E	FY2019E
Valuation Ratio (x)						
P/E (on FDEPS)	18.6	18.1	17.1	32.5	33.8	23.2
P/CEPS	14.3	13.6	13.8	17.6	17.7	13.9
P/BV	4.4	3.6	3.1	3.2	3.0	2.7
Dividend yield (%)	0.6	0.6	0.6	0.6	0.6	0.6
EV/Sales	3.1	2.7	2.6	3.0	3.1	2.7
EV/EBITDA	13.2	12.1	10.4	18.5	17.4	13.6
EV / Total Assets	3.1	2.7	2.5	2.5	2.3	2.1
Per Share Data (₹)						
EPS (Basic)	126.7	130.2	138.2	72.6	69.9	102.0
EPS (fully diluted)	126.7	130.2	138.2	72.6	69.9	102.0
Cash EPS	165.5	174.0	171.7	134.5	133.4	169.3
DPS	15.0	15.0	15.0	15.0	15.0	15.0
Book Value	534.7	653.3	752.3	739.6	785.4	863.3
Dupont Analysis						
EBIT margin	18.6	17.1	18.6	8.8	10.0	13.0
Tax retention ratio	80.9	78.8	73.7	82.2	72.6	75.4
Asset turnover (x)	1.2	1.1	1.0	0.9	0.8	0.8
ROIC (Post-tax)	17.4	15.1	14.3	6.4	5.8	8.3
Cost of Debt (Post Tax)	0.0	0.0	0.0	0.0	0.0	0.0
Leverage (x)	0.4	0.4	0.3	0.3	0.4	0.4
Operating ROE	24.7	20.4	18.3	8.5	8.2	11.5
Returns (%)						
ROCE (Pre-tax)	20.2	18.1	18.7	7.5	7.7	10.3
Angel ROIC (Pre-tax)	25.6	22.5	22.9	10.1	11.4	15.0
ROE	26.3	21.9	19.7	9.6	9.2	12.4
Turnover ratios (x)						
Asset Turnover (Gross Block)	3.5	3.6	3.2	2.7	2.4	2.3
Inventory / Sales (days)	62	61	60	62	63	65
Receivables (days)	89	90	96	89	91	94
Payables (days)	40	43	59	40	39	40
WC cycle (ex-cash) (days)	97	96	89	98	98	90
Solvency ratios (x)						
Net debt to equity	0.4	0.3	0.2	0.4	0.4	0.4
Net debt to EBITDA	1.2	1.0	0.8	2.2	2.1	1.8
Interest Coverage (EBIT / Int.)	-	-	-	-	-	1.0

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Ratings (Based on expected returns over 12 months investment period):	Buy (> 15%)	Accumulate (5% to 15%) Reduce (-5% to -15%)	Neutral (-5 to 5%) Sell (< -15)
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