

Dr Reddy's Laboratories

Performance Highlights

Y/E March (₹ cr)	2QFY2016	1QFY2016	% chg (qoq)	2QFY2015	% chg (yoy)
Net sales	3,989	3,758	6.2	3,588	11.2
Gross profit	2,674	2,522	6.0	2,286	17.0
Operating profit	1,121	986	13.7	807	38.8
Adj. net profit	722	625	15.5	574	25.7

Source: Company, Angel Research

For 2QFY2016, Dr Reddy's Laboratories (DRL) posted in line sales while the net profit growth exceeded our estimates. The company posted an 11.2% yoy growth in sales to ₹3,989cr V/s ₹4,000cr expected and V/s ₹3,588cr in 2QFY2015, mainly driven by global generics. On the operating front, the EBIT margin came in at 22.4% V/s 18.7% expected and V/s 17.3% in 2QFY2015, driven by the expansion in gross margins (285bps) and SG&A and R&D expenditure growing only moderately, which is by 3.6% and 8.8% yoy, respectively. Thus, the net profit came in at ₹722cr V/s ₹631cr expected and V/s ₹574cr in 2QFY2015, a yoy growth of 25.7%. After the warning letters for its three facilities, the stock has corrected, making valuations attractive. **Thus we recommend a Buy rating on the stock.**

Results better on operating front: The company posted an 11.2% growth in sales to ₹3,989cr V/s ₹4,000cr expected and V/s ₹3,588cr in 2QFY2015, mainly driven by global generics. Global generics (₹3,276.8cr) posted a growth of 15% yoy, while PSAI (₹591.8cr) posted a dip of 7% yoy. In global generics, the key markets-USA, Europe, India and Emerging markets, posted a growth of 32%, 65%, 14% and -22% yoy, respectively. On the operating front, the EBIT margin came in at 22.4% V/s 18.7% expected and V/s 17.3% in 2QFY2015, driven by expansion in gross margins (285bps) and moderate growth in SG&A and R&D expenditure, which rose by 3.6% and 8.8% yoy, respectively. Thus, the net profit came in at ₹722cr V/s ₹631cr expected and V/s ₹574cr in 2QFY2015, a yoy growth of 25.7%.

Outlook and valuation: We expect net sales to grow at a CAGR of 14.9% to ₹19,575cr and adjusted EPS to record a 17.2% CAGR to ₹178.8 over FY2015-17E. **On back of valuations, we recommend a Buy rating on the stock.**

Key financials (IFRS Consolidated)

Y/E March (₹ cr)	FY2014	FY2015	FY2016E	FY2017E
Net sales	13,217	14,819	16,838	19,575
% chg	13.7	12.1	13.6	16.3
Net profit	2,151	2,218	2,585	3,046
% chg	28.2	3.1	16.5	17.9
Adj net profit	2,151	2,218	2,585	3,046
% chg	22.9	3.1	16.5	17.9
Adj. EPS (₹)	126.7	130.2	151.7	178.8
EBITDA margin (%)	23.6	22.2	23.0	23.1
P/E (x)	26.7	26.0	22.3	18.9
RoE (%)	26.3	21.9	21.1	20.8
RoCE (%)	20.2	18.1	18.8	19.5
P/BV (x)	6.3	5.2	4.3	3.6
EV/Sales (x)	4.4	3.9	3.4	2.8
EV/EBITDA (x)	18.7	17.4	14.7	12.3

Source: Company, Angel Research; Note: CMP as of November 13, 2015

BUY

CMP	₹3,384
Target Price	₹3,933

Investment Period 12 Months

Stock Info

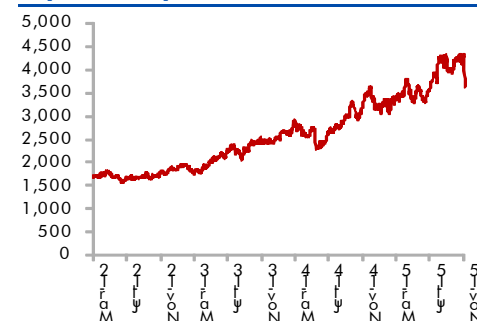
Sector	Pharmaceutical
Market Cap (₹ cr)	57,735
Net Debt (₹ cr)	(396)
Beta	0.8
52 Week High / Low	4,383/3,010
Avg. Daily Volume	26,988
Face Value (₹)	5
BSE Sensex	25,611
Nifty	7,762
Reuters Code	REDY.BO
Bloomberg Code	DRRD@IN

Shareholding Pattern (%)

Promoters	25.5
MF / Banks / Indian Fls	8.8
FII / NRIs / OCBs	58.0
Indian Public / Others	7.7

Abs. (%)	3m	1yr	3yr
Sensex	(7.0)	(8.3)	37.6
Dr Reddy	(21.1)	(2.6)	92.8

3-year Daily Price Chart



Source: Company, Angel Research

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Exhibit 1: 2QFY2016 performance (IFRS, consolidated)

Y/E March (₹ cr)	2QFY2016	1QFY2016	% chg (qoq)	2QFY2015	% chg (yoy)	1HFY2016	1HFY2015	% chg
Net sales	3,989	3,758	6.2	3,588	11.2	7,747	7,105	9.0
Other income	10	34	(70)	69	(84.8)	45	135	(67.0)
Total income	3,999	3,792	5.5	3,657	9.4	7,791	7,240	7.6
Gross profit	2,694	2,522	6.8	2,286	17.8	5,215	4,566	14.2
Gross margin (%)	67.5	67.1		63.7		67.3	64.3	
SG&A expenses	1,106	1,097	0.8	1,067	3.6	2,203	2,135	3.2
R&D expenses	447	439	2.0	411	8.8	886	799	10.9
EBDITA	1,140	986	15.7	807	41.3	2,126	1,632	30.3
EBDITA (%)	28.6	26.2	-	22.5		27.4	23.0	-
Depreciation	247	227	8.7	187.2	31.7	473.4	382.9	(51.1)
Interest	-	-	-	-	-	-	-	-
PBT	904	793	14.1	689	31.3	1,697	1,384	(50.2)
Tax	188	172	9.2	120	57.1	360	270	33.3
Net Profit	716	621	15.4	569	25.9	1,337	1,114	20.0
Share of profit/ (loss) in associates	4.4	4.4	0.0	5.1		8.8	10.6	
Reported net profit before exceptional	722	626	15.4	574	25.7	1,348	1,125	19.8
Exceptional items (loss) /profit	-	-	-	-	-	-	-	-
Reported PAT	722	625	15.5	574	25.7	1,348	1,125	19.8
Adj.Net Profit	722	625	15.5	574	25.7	1,348	1,125	19.8
EPS (₹)	42.5	36.8		33.8		79.4	66.2	

Source: Company, Angel Research

Exhibit 2: Actual vs Estimates

(₹ cr)	Actual	Estimates	Variation (%)
Net sales	3,989	4,000	(0.3)
Other income	10	69	(84.8)
Operating profit	1,121	746	50.1
Tax	188	184	2.1
Adj. Net profit	722	631	14.4

Source: Company, Angel Research

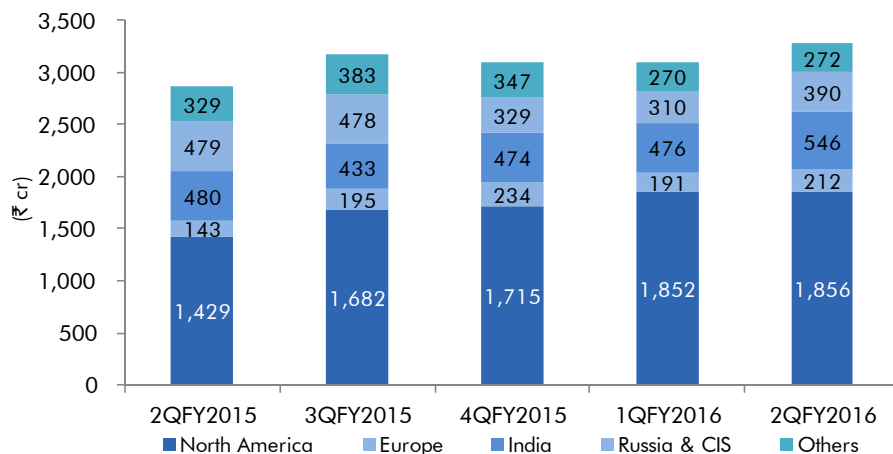
Revenue just in line with expectation: The company posted an 11.2% growth in sales to ₹3989cr V/s ₹4,000cr expected and V/s ₹3,588cr in 2QFY2015, mainly driven by global generics. Global generics (₹3,276.8cr) posted a growth of 15% yoy, while PSAl (₹591.8cr) posted a dip of 7% yoy. In global generics, the key markets- USA, Europe, India and Emerging markets, posted a growth of 32%, 65%, 14% and -22% yoy, respectively.

In the generic segment (accounting for 82% of sales), the US (₹1,856cr) grew by 32% yoy, Europe (₹212cr) grew by 65.0% yoy, India (₹546cr) grew by 14.0% yoy, while Emerging Markets (including Russia & CIS; ₹662cr) de-grew by 22% yoy. Russia & CIS (~₹390cr) dipped by 18.6% yoy. Revenue from Russia declined primarily on account of the Rouble's depreciation. In constant currency terms, the growth was of ~11% yoy for 2QFY2016. Revenue from Rest of the World (RoW) territories, at ~₹270cr, recorded a yoy de-growth of 24%.

In the PSAI segment (15% of sales) - US de-grew by 47% and ROW grew by 26%. Europe de-grew by 5% while India dipped by 19% yoy, during the quarter. Proprietary Products & Others (₹120cr) posted a yoy growth of 37%.

DRL filed 2 abbreviated new drug applications (ANDAs) during the quarter. The company has 76 ANDAs pending for approval with the USFDA, of which, 50 are Para IVs and 18 are FTFs.

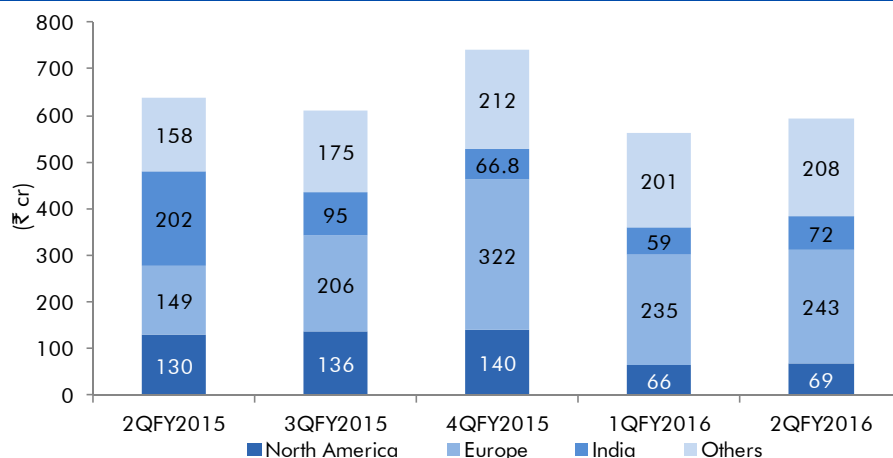
Exhibit 3: Trend in Global generics



Source: Company, Angel Research

In the PSAI segment (15% of sales) - US de-grew by 47% and ROW grew by 26%. Europe de-grew by 5% while India dipped by 19% yoy, during the quarter. Proprietary Products & Others (₹120cr) posted a yoy growth of 37%.

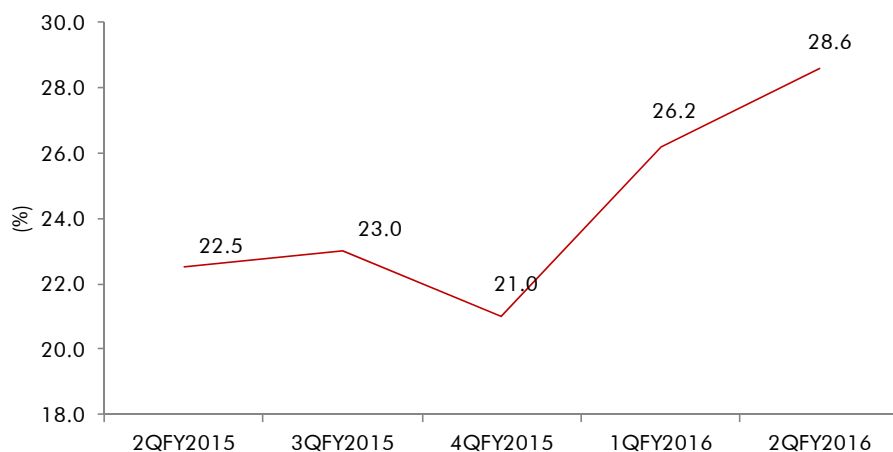
Exhibit 4: PSAI trend



Source: Company, Angel Research

EBITDA expands yoy: On the operating front, the EBITDA margin came in at 28.6% V/s 24.8% expected V/s 22.5% in 2QFY2015, driven by the expansion in gross margins (285bps) and moderate growth in SG&A and R&D expenditure, which rose by 3.6% and 8.8% yoy, respectively. The expansion in gross margins is on back of improved sales mix (with formulations at 82% of sales in 2QFY2016 V/s 80% in 2QFY2015).

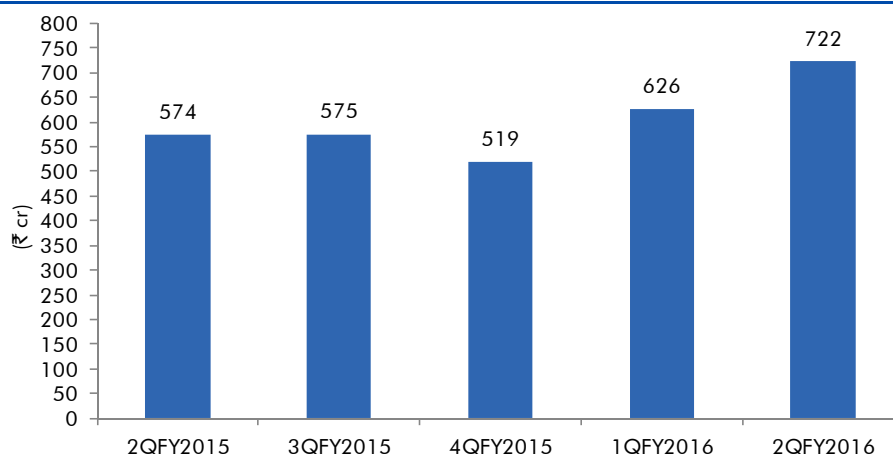
Exhibit 5: EBITDA margin trend (%)



Source: Company, Angel Research

Net profit lower than expected: Consequently, the net profit came in at ₹722cr V/s ₹631cr expected and V/s ₹574cr in 2QFY2015, a yoy growth of 25.7%. Other income during the quarter came in at ₹10cr V/s ₹69cr in 2QFY2015, which led the PAT to grow at a lower rate than the operating profit growth rate during the period.

Exhibit 6: Adjusted net profit trend



Source: Company, Angel Research

Concall takeaways

- DRL spends 12-15% of its R&D expenditure on biosimilars.
- Russia business is to see revival in 2HFY2016.
- Improvement in SG&A is likely to be sustainable.
- Dr Reddy's has received a warning letter issued by the USFDA, relating to its three plants Srikakulam, and Miryalaguda, Telegana along with the oncology formulation business at Duvvada. The company has said that these facilities contribute around 10-12% of sales of the company. Though it cannot be ruled but probability of adverse action at Bachupally plant (which got inspected by USFDA in June 2015 with some 483 observations) is low now as it did not receive warning letter along with above mentioned facilities. This is a key facility for DRRD as it contributes >50% to current US sales. Moreover, these observations are minor.
- USFDA needs DRL to focus on third party verification and implementation across the manufacturing network. The company has not done any third party verification till date.
- DRL plans to arrest the impact partially by initiating site transfers from its API plants (though this may lead to delay of 6-9 months). DRL generates ~20% of its US sales currently from Oncology segment but exposure to current sales from Duvvada facility is limited. This is because most of the supply comes from third party sources.
- The Gleevec API is outsourced from the third party and the company is expected to launch this product post Sun Pharma's exclusivity.

Investment arguments

Robust growth in the US, going ahead: After attaining a critical mass (US\$1,113mn in FY2015), DRL aims to scale up its business to the next orbit in the US market on the back of a strong product pipeline (76 ANDAs are pending approval, of which, 50 are Para IVs and 18 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. On back of the import alert on the three facilities of the company, on worst case scenario, we expect the ex-exclusivity US sales to post a CAGR of ~15.7% during FY2015-17E.

Domestic back in focus: DRL reported a 14.0% yoy growth in FY2015. 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 has 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. Thus, we expect sales in India to post a CAGR of ~20.1% over FY2015-17E.

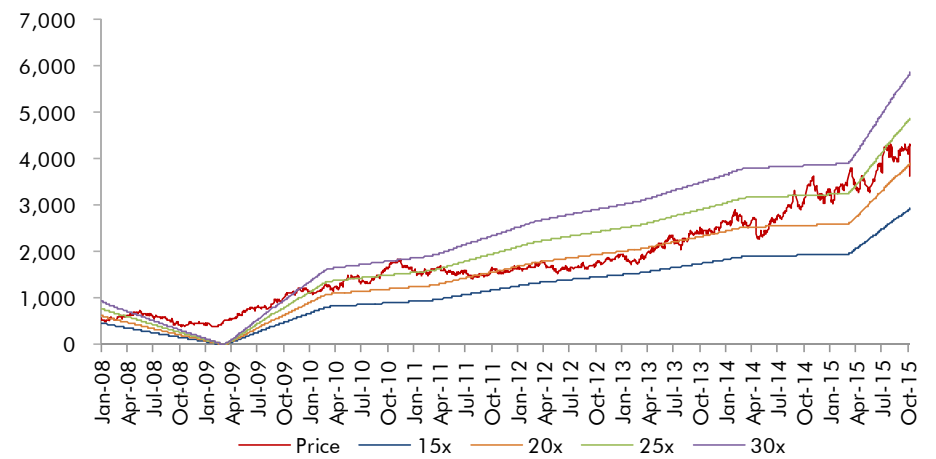
Valuation: We expect net sales to grow at a CAGR of 14.9% to ₹19,575cr and adjusted EPS to record a 17.2% CAGR to ₹178.8 over FY2015-17E. The stock has seen severe beating post the import alert from the USFDA. Considering the attractive valuations, we **recommend a Buy rating on the stock.**

Exhibit 7: Key assumptions

	FY2016E	FY2017E
PSAI segment growth (%)	13.4	13.7
Generics segment growth (%)	26.4	18.2
Operating margin (%)	25.0	23.1
Capex (₹ cr)	1000	1000

Source: Company, Angel Research

Exhibit 8: One-year forward PE chart



Source: Company, Angel Research

Exhibit 9: Recommendation summary

Company	Reco.	CMP (₹)	Tgt Price (₹)	Upside (%)	FY2017E			FY15-17E	FY2017E	
					PE (x)	EV/Sales (x)	EV/EBITDA (x)	CAGR in EPS (%)	RoCE (%)	RoE (%)
Alembic Pharma	Neutral	662	-	-	27.7	3.9	19.5	26.1	30.3	30.2
Aurobindo Pharma	Accumulate	830	872	5.1	19.0	3.1	13.3	16.3	23.4	30.2
Cadila Healthcare	Neutral	413	-	-	23.5	3.5	16.1	24.6	25.2	29.0
Cipla	Neutral	619	-	-	21.4	2.9	15.3	21.4	17.1	16.8
Dr Reddy's	Buy	3,384	3,933	16.2	18.9	2.8	14.7	17.2	19.1	20.6
Dishman Pharma	Neutral	381	-	-	17.6	1.7	8.2	20.4	11.7	11.7
GSK Pharma*	Neutral	3,152	-	-	46.2	8.0	36.4	6.6	33.7	34.3
Indoco Remedies	Neutral	300	-	-	22.1	2.4	13.1	23.0	19.7	19.7
Ipca labs	Buy	719	900	25.1	25.7	2.6	13.7	17.9	11.8	14.0
Lupin	Neutral	1,777	-	-	26.0	4.5	16.6	13.1	29.6	24.7
Sanofi India*	Neutral	4,586	-	-	30.3	4.0	19.0	33.1	27.9	25.5
Sun Pharma	Buy	742	950	28.1	27.6	4.8	15.6	8.4	15.8	16.6

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 and Active Ingredients, Global Generics and Proprietary Products. The key therapeutic focus is on gastro-intestinal, cardiovascular, diabetology, oncology, pain management, anti-infective and paediatrics. The key markets for DRL include India, USA, Russia & CIS, and Germany.

Profit & loss statement (IFRS Consolidated)

Y/E March (₹ cr)	FY2012	FY2013	FY2014	FY2015	FY2016E	FY2017E
Net sales	9,674	11,627	13,217	14,819	16,838	19,575
Other operating income	76.5	247.9	141.6	91.7	91.7	91.7
Total operating income	9,750	11,875	13,359	14,911	16,930	19,666
% chg	29.2	21.8	12.5	11.6	13.5	16.2
Total expenditure	7,076	8,951	10,096	11,535	12,627	15,061
Cost of revenues	3,598	4,825	4,977	5,531	5,808	7,133.31
SG&A expenses	2,887	3,358	3,878	4,259	4,833	5,618
R&D expenses	591.1	767.3	1,240.2	1,744.9	1,986.9	2,309.8
EBITDA	2,598	2,676	3,121	3,284	4,211	4,514
% chg	65.9	3.0	16.6	5.2	28.2	7.2
(% of Net Sales)	26.9	23.0	23.6	22.2	25.0	23.1
Depreciation & amortisation	745.4	743.7	659.8	747.4	927.4	990.1
EBIT	1,853	1,932	2,462	2,537	3,283	3,523
% chg	60.9	4.3	27.4	3.1	29.4	7.3
(% of Net Sales)	19.2	16.6	18.6	17.1	19.5	18.0
Interest & other charges	(16.0)	-	-	-	-	-
Other Income	-	46.0	40.0	168.2	168.2	168.2
(% of PBT)	-	2.1	1.5	6.0	4.7	4.4
Share in profit of associates	5.4	10.4	17.4	19.5	19.5	19.5
Recurring PBT	1,951	2,237	2,661	2,816	3,563	3,803
% chg	61.5	14.7	19.0	5.9	26.5	6.7
Extraordinary expense/(Inc.)	104.0	68.8	-	-	-	-
PBT (reported)	1,846.6	2,167.7	2,660.6	2,816.3	3,562.9	3,802.8
Tax	420.4	490.0	509.4	598.4	708.7	756.7
(% of PBT)	22.8	22.6	19.1	21.2	19.9	19.9
PAT (reported)	1,426.2	1,677.7	2,151.2	2,217.9	2,854.2	3,046.2
Add: Share of earnings of asso.	-	-	-	-	-	-
Less: Minority interest (MI)	-	-	-	-	-	-
Exceptional items	-	-	-	-	-	-
PAT after MI (reported)	1,426.2	1,677.7	2,151.2	2,217.9	2,854.2	3,046.2
ADJ. PAT	1,496.0	1,750.0	2,151.2	2,217.9	2,854.2	3,046.2
% chg	39.0	17.0	22.9	3.1	28.7	6.7
(% of Net Sales)	14.7	14.4	16.3	15.0	17.0	15.6
Basic EPS (₹)	88.2	103.1	126.7	130.2	167.5	178.8
Fully Diluted EPS (₹)	88.2	103.1	126.7	130.2	167.5	178.8
% chg	38.4	16.8	22.9	2.7	23.3	18.1

Balance sheet (IFRS Consolidated)

Y/E March (₹ cr)	FY2012	FY2013	FY2014	FY2015	FY2016E	FY2017E
SOURCES OF FUNDS						
Equity share capital	84.8	84.9	84.9	85.2	85.2	85.2
Preference Capital	-	-	-	-	-	-
Reserves & surplus	5,660	7,224	8,995	11,045	13,500	16,148
Shareholders funds	5,744	7,309	9,080	11,130	13,586	16,233
Minority Interest	-	-	-	-	-	-
Total loans	4,831.2	3,676.0	4,474.2	3,954.3	3,954.3	3,954.3
Deferred tax liability	83.3	83.3	(192.9)	(401.3)	(401.3)	(401.3)
Total liabilities	10,659	11,068	13,361	14,683	17,139	19,786
APPLICATION OF FUNDS						
Net fixed assets	3,325	3,781	3,945	4,314	5,314	6,314
Goodwill /other intangibles	1,353	1,402	1,470	1,643	1,643	1,643
Capital Work-in-Progress	520.8	495.2	495.2	495.2	495.2	495.2
Investments	1,077	1,764	2,589	3,811	3,811	3,811
Current Assets	6,995	6,875	7,866	8,558	10,511	12,909
Cash	737.9	513.6	845	539	1,427	2,355
Loans & Advances	580.4	697.6	793.0	889.1	1,010.3	1,174.5
Other	5,677	5,664	6,228	7,129	8,074	9,379
Current liabilities	2,613	3,252	3,006	4,214	4,639	5,389
Net Current Assets	4,382	3,623	4,860	4,344	5,873	7,520
Other Assets	-	-	-	76	-	-
Total Assets	10,659	11,068	13,361	14,683	17,139	19,786

Cash flow statement (IFRS Consolidated)

Y/E March (₹ cr)	FY2012	FY2013	FY2014	FY2015	FY2016E	FY2017E
Profit before tax	1,951	2,237	2,661	2,816	3,563	3,803
Depreciation	745	744	660	747	927	990
(Inc)/Dec in Working Capital	(1,661)	535	(906)	211	(641)	(719)
Less: Other income	-	46	40	168	168	168
Direct taxes paid	420	490	509	598	709	757
Cash Flow from Operations	614	2,980	1,865	3,008	2,973	3,149
(Inc.)/Dec.in Fixed Assets	(881)	(431)	(164)	(369)	(1,000)	(1,000)
(Inc.)/Dec. in Investments	(1,046)	687	824	1,222	-	-
Other income	-	46	40	168	168	168
Cash Flow from Investing	(1,928)	302	701	1,021	(832)	(832)
Issue of Equity	0	0	-	0	-	-
Inc./Dec.) in loans	2,474	(1,155)	798	(520)	-	-
Dividend Paid (Incl. Tax)	259	298	358	399	399	399
Others	(1,255)	(2,649)	(3,390)	(4,214)	(1,652)	(1,788)
Cash Flow from Financing	1,478	(3,506)	(2,234)	(4,335)	(1,253)	(1,389)
Inc./Dec.) in Cash	165	(224)	331	(306)	888	928
Opening Cash balances	573	738	514	845	539	1,427
Closing Cash balances	738	514	845	539	1,427	2,355

Key ratios

Y/E March	FY2012	FY2013	FY2014	FY2015	FY2016E	FY2017E
Valuation Ratio (x)						
P/E (on FDEPS)	38.4	32.8	26.7	26.0	20.2	18.9
P/CEPS	26.4	23.7	20.4	19.4	15.2	14.3
P/BV	10.0	7.9	6.3	5.2	4.2	3.6
Dividend yield (%)	0.4	0.4	0.4	0.4	0.4	0.4
EV/Sales	6.2	5.1	4.4	3.9	3.3	2.8
EV/EBITDA	23.3	22.0	18.7	17.4	13.4	12.3
EV / Total Assets	5.7	5.3	4.4	3.9	3.3	2.8
Per Share Data (₹)						
EPS (Basic)	88.2	103.1	126.7	130.2	167.5	178.8
EPS (fully diluted)	88.2	103.1	126.7	130.2	167.5	178.8
Cash EPS	128.0	142.6	165.5	174.0	222.0	236.9
DPS	14.0	15.0	15.0	15.0	15.0	15.0
Book Value	338.7	430.4	534.7	653.3	797.4	952.8
Dupont Analysis						
EBIT margin	19.2	16.6	18.6	17.1	19.5	18.0
Tax retention ratio	77.2	77.4	80.9	78.8	80.1	80.1
Asset turnover (x)	1.2	1.2	1.2	1.1	1.1	1.2
ROIC (Post-tax)	17.5	14.9	17.4	15.1	17.7	17.1
Cost of Debt (Post Tax)	0.0	0.0	0.0	0.0	0.0	0.0
Leverage (x)	0.6	0.6	0.4	0.4	0.2	0.1
Operating ROE	27.2	23.5	24.7	20.4	22.1	19.5
Returns (%)						
ROCE (Pre-tax)	20.9	17.8	20.2	18.1	20.6	19.1
Angel ROIC (Pre-tax)	29.6	23.1	25.6	22.5	25.7	24.4
ROE	28.9	26.8	26.3	21.9	23.1	20.4
Turnover ratios (x)						
Asset Turnover (Gross Block)	3.4	3.3	3.5	3.6	3.5	3.4
Inventory / Sales (days)	66	63	62	61	66	69
Receivables (days)	80	88	89	90	95	101
Payables (days)	46	44	40	43	43	42
WC cycle (ex-cash) (days)	105	104	97	96	89	89
Solvency ratios (x)						
Net debt to equity	0.7	0.4	0.4	0.3	0.2	0.1
Net debt to EBITDA	1.6	1.2	1.2	1.0	0.6	0.4
Interest Coverage (EBIT / Int.)	-	-	-	-	-	-

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Disclosure of Interest Statement

Dr. Reddy's Laboratories

1. Analyst ownership of the stock	No
2. Angel and its Group companies ownership of the stock	No
3. Angel and its Group companies' Directors ownership of the stock	No
4. Broking relationship with company covered	No

Note: We have not considered any Exposure below ₹1 lakh for Angel, its Group companies and Directors

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%)