November 08, 2019

Dr. Reddy's Laboratories Ltd.: [ICRA]AA+(Stable) assigned for enhanced amount; short-term rating withdrawn

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Long-term, Fund-based / Non-fund Based Limits	100.0	500.0	[ICRA]AA+ (Stable); assigned /outstanding
Short-term, Fund-based / Non-fund Based Limits	300.0	-	[ICRA]A1+; withdrawn^
Total	**400.0**	**500.0**	

**Instrument details are provided in Annexure-1*
^Limits now being rated on long-term scale

Rationale

The rating continues to derive comfort from Dr. Reddy's Laboratories Ltd's (DRL's) geographically diversified revenue mix, integrated presence across the value chain, healthy product pipeline and robust financial profile as evinced by its healthy debt coverage indicators. The rating also factors in the company's increasing focus on limited competition niche products, injectables and biosimilars, which are expected to provide a fillip to its revenues in the medium term, given its strong research and development (R&D) capabilities. As on September 30, 2019, DRL had 96 abbreviated new drug applications (ANDAs) and three new drug applications (NDAs) pending approval from the US Food and Drug Administration (USFDA). DRL's liquidity position is strong, supported by its sizeable consolidated cash and bank balances and liquid investments of Rs. 3,044 crore and undrawn working capital limits (consolidated) of Rs. 5,142.5 crore as on September 30, 2019.

After witnessing a modest growth of 1% in operating income (OI) in FY2018, the revenue growth for DRL improved to 8% and 15% in FY2019 and H1 FY2020, respectively. While the revenue growth remained flat in the key North American market on account of price erosion, the improvement in the OI was led by healthy double digit growth in the emerging markets and the domestic market on account of new product launches as well as improved offtake in the base business. Despite the impact of the voluntary sales recall of ranitidine and the logistics issue faced by the company for its products in the US, the revenue growth in H1 FY2020 was adequately supported by a one-time licensing income of Rs. 722.9 crore for the US and select territory rights for two of its neurology brands (under the proprietary products division) as well as strong YoY growth of 31% in Europe.

DRL's operating profit margins (OPM) also improved to 20.6% and 20.8% in FY2019 and H1 FY2020, respectively, from 16.5% in FY2018, aided by improved revenue growth and several cost rationalisation initiatives undertaken by the company. However, it remained lower than earlier levels, due to lower limited competition launches as well as continued price erosion being witnessed in the base business in the US. The net profits, however, remained adequately supported by the increased non-operating income – DRL sold two of its manufacturing facilities (including one formulations and one active pharmaceutical ingredients or API facility) in FY2019 as well as received Rs. 345.7 crore of income in Q1 FY2020 from Celgene, pursuant to a settlement agreement entered into for gRevlimid towards damages under Section 8 of the Canadian Patented Medicines (Notice of Compliance) Regulations. Coupled with strict control on working capital intensity and limited capital expenditure (capex), the above led to an improvement in return indicators, as evinced by a return on capital employed (ROCE) of 16.4% in FY2019 and 21.9% in H1 FY2020.

DRL's product pipeline for the US remains strong, though the company is facing delays in the launch of two of its key products - gNuvaring and gCopaxone, which are now expected to be launched in FY2021, vis-a-vis earlier expectations of H1 CY2019 and H2 CY2019, respectively. The company is also yet to resolve the warning letter issued to its API plant at Srikakulam in November 2015, though it has successfully resolved the warning letters issued to its formulations facility at Duvvada (Andhra Pradesh) and the API facility at Miryalaguda (Telangana). DRL's ability to maintain a healthy product portfolio in the US markets, improve its market share in key products and geographies as well as its capability to resolve the regulatory issues at its manufacturing facility are critical for the revenue and profitability growth of the company and are the key rating sensitivities. The profitability of the company also remains vulnerable to foreign exchange fluctuations on account of its foreign operations as well as foreign currency borrowings, though it hedges the same through both derivative and non-derivative financial instruments, such as foreign exchange forward contracts, option contracts and currency swap contracts. The rating also factors in the pending resolution of the ongoing industry-wide investigation by the anti-trust division of the US Department of Justice (DOJ) pertaining to price-fixing and price-collusion allegations. Large inorganic investments by the company would remain an event risk, and the impact of such investments on the company's business and credit profile would be monitored on a case-by-case basis.

ICRA expects DRL to continue to maintain its heathy credit profile, aided by strong cash accruals supported by an improvement in its revenue run-rate across major geographies as well as the continued cost optimisation measures undertaken.

ICRA has also withdrawn the short-term rating of [ICRA]A1+ (pronounced ICRA A one plus) assigned to the Rs. 300-crore unallocated fund-based and non-fund based limits of DRL. These limits are now being rated on long-term scale, as per the request received from the company.

Key rating drivers

Credit strengths

Well diversified geographic mix, with a strong presence in key generic markets globally – DRL has a presence in both the emerging and the developed generics markets, with the US and Europe together contributing ~41% to its total sales in H1 FY2020.

Integrated presence across the value chain – DRL has a strong and well-diversified business model supported by its generic business (with the US being the key market), its branded formulations business (in India and the emerging markets), and backward integration in APIs. Around 60-65% of the global generics segment sales are from its vertically integrated APIs.

Strong R&D capabilities supporting development of a strong generic product pipeline (including first-to-file products, complex technology products and biosimilars) in developed markets – DRL has been investing significantly in R&D (9% of its net sales in FY2019), in line with its strategy to expand its focus on complex formulations, differentiated formulations and biosimilar compounds. DRL is one of the few Indian companies to have forayed into new drug discovery and development (NDDD) and new chemical entity (NCE) research, with a focus on therapies like dermatology, anti-inflammatory and anti-infectives as well as biosimilars.

Strong pipeline of limited competition products for the US generic market – The company launched 24 and 13 products in the US in FY2019 and H1 FY2020, respectively, and has a strong product pipeline. As on September 30, 2019, DRL had 96 ANDAs[1] and three NDAs pending approval from the USFDA. Near-term US revenue build-up hinges on the company's ability to maintain healthy product portfolio in the US market, achieve a healthy revenue scale-up for products already launched as well as secure timely approval for key launches, including gCopaxone and gNuvaring.

Healthy financial profile and robust debt-coverage indicators – DRL's total consolidated net debt as on September 30, 2019 stood at Rs. 109.8 crore, resulting in a comfortable (net) gearing of 0.01x. The coverage indicators also remain robust, as reflected by net debt/OPBDITA of 0.03x, OPBITDA/Interest of 30.0 times and NCA/Total Debt of 88% for H1 FY2020.

Credit challenges

Constrained, though improving, profitability over the last two years due to absence of meaningful limited competition product launches – The revenues and profitability of the company had been impacted in FY2017 and FY2018 following headwinds in the US market due to price erosion in its key products on account of channel consolidation in the US and increased competitive intensity. Consequently, its OPM declined to 16.5% in FY2018 from 25.6% in FY2016. The OPM improved in FY2019 and H1 FY2020 to 20.6% and 20.8%, respectively, aided by improved revenue growth and several cost rationalisation initiatives undertaken by the company. However, it remains lower than earlier levels, due to lower limited competition launches as well as continued price erosion being witnessed in the base business in the US. Timely launch of the limited competition products and ability of the company to garner a meaningful market share within a reasonable time frame remain critical.

Warning letter issued to the Srikakulam API facility and on-going industry-wide investigation – DRL had received a warning letter for its API plant at Srikakulam in November 2015. The company has responded to all the queries of the USFDA and is awaiting re-inspection of this site. The company has successfully resolved the warning letters issued to its formulations facility at Duvvada (Andhra Pradesh) and API facility at Miryalaguda (Telangana). The rating also factors in the pending resolution of the on-going industry-wide investigation by the anti-trust division of the US DOJ pertaining to price-fixing and price-collusion allegations.

Vulnerability of profitability to foreign exchange fluctuations – The profitability of the company also remains vulnerable to foreign exchange fluctuations on account of its foreign operations as well as foreign currency borrowings, though the company hedges the same through both derivative and non-derivative financial instruments, such as foreign exchange forward contracts, option contracts and currency swap contracts.

Liquidity Position: Strong

The liquidity position of DRL is strong marked by consolidated unencumbered cash and bank balances and liquid investments of Rs. 3,044 crore and undrawn working capital limits (consolidated) of Rs. 5,142.5 crore as on September 30, 2019. The cash flow generation of the company is also expected to remain strong in FY2020 supported by improvement in revenue growth across major geographies, limited capex plans as well as cost optimisation measures being undertaken by the company.

[1] *During Q2 FY2020, DRL impaired three product related intangibles acquired from TEVA in August 2016 (viz., Ramelteon, Tobramycin and Imiquimod) and recognised an impairment charge of Rs. 355.1 crore*

Rating sensitivities

Positive triggers: The rating may be upgraded if there is a sustained improvement in the market share of the company in its key geographies and a substantial growth in its revenues and profitability, leading to sustained improvement in return indicators and further strengthening of its financial risk profile.

Negative triggers: The rating may be downgraded if there is weakening in the company's profitability, leading to a sustained fall in ROCE below 15%. Delay in resolution of existing regulatory non-compliances or any other regulatory non-compliance issued to DRL for its products and/or manufacturing facilities, thereby impacting its product launches and thus revenues and profitability, would also be a negative trigger. Large debt-funded inorganic investments by the company or any adverse outcome of on-going investigations would remain an event risk, and the impact of such investments on the company's business and credit profile would be monitored on a case by case basis.

Analytical approach:

Analytical Approach	Comments
Applicable Rating Methodologies	Corporate rating methodology Methodology for Pharmaceutical Industry
Parent / Group Support	Not Applicable.
Consolidation / Standalone	For arriving at the ratings, ICRA has considered the consolidated financials of DRL. As on September 30, 2019, the company had 50 subsidiaries, two joint ventures and two other consolidating entities (where the company does not have any equity interests, but has significant influence or control over it), that are enlisted in Annexure-2.

About the company

DRL was incorporated by its promoter and founder chairman, the Late Dr. K. Anji Reddy, as a private limited company on February 24, 1984. The company was subsequently converted to a public limited one on December 6, 1985 and listed on the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) in August 1986 as well as on the New York Stock Exchange (NYSE) on April 11, 2001. As on September 30, 2019, the promoters and the promoter Group held 26.76% stake in the company.

DRL offers a portfolio of products and services, including pharmaceutical generics, APIs, custom pharmaceutical services, biosimilars and differentiated formulations. It has three divisions—global generics (accounted for 76% of the revenues of the company in H1 FY2020), pharmaceutical services and active ingredients (accounted for 13% of the revenues of the company in H1 FY2020) and proprietary products (accounted for 10% of the revenues of the company in H1 FY2020). The major therapeutic areas of focus for the company include gastro-intestinal, cardiovascular, diabetology, oncology, pain management and dermatology, with the US, India, Russia and the Commonwealth of Independent States (CIS) countries being the major markets.

DRL, currently, has nine API-manufacturing facilities, of which seven are USFDA approved (six in India and one in Mexico) and 13 formulations manufacturing facilities (including the ones through JVs). Of these, the company has received warning letter from the USFDA for its API facility at Srikakulam. In addition, the company has one biologics facility in India and several technology development and R&D centres in India and across the globe. DRL has a 10-member Board, comprising two promoter directors and eight independent directors, each an eminent personality in the field of finance, strategic consulting, science and economics.

For the six-month period ended September 30, 2019, DRL reported a profit after tax (PAT) of Rs. 1,783.3 crore on an operating income (OI) of Rs. 8,671.0 crore, as against PAT of Rs. 994.4 crore on an OI of Rs. 7,554 crore for the six-month period ended September 30, 2018.

Key financial indicators (audited, consolidated)

	FY2018	FY2019
Operating Income (Rs. crore)	14,281.0	15,448.2
PAT (Rs. crore)	912.4	1,906.2
OPBDIT/ OI (%)	16.5%	20.6%
RoCE (%)	10.2%	16.4%
Total Outside Liabilities/ TNW (times)	0.8	0.6
Total Debt/ OPBDIT (times)	2.2	1.2
Interest Coverage (times)	29.9	35.8
DSCR	25.9	31.7

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years:

	Instrument	Current Rating (FY2020)				Chronology of Rating History for the Past 3 years			
		Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	Date & Rating	Date & Rating in FY2019	Date & Rating in FY2018		Date & Rating in FY2016
					08-Nov-19	14-Dec-18	15-Sep-17	1-Sep-17	02-Mar-16
1	Fund-based / Non-fund Based Limits	Long-term	500.0	-	[ICRA]AA+ (Stable)	[ICRA]AA+ (Stable)	[ICRA]AA+ (Stable)	-	-
2	Fund-based / Non-fund Based Limits	Short-term	-	-	[ICRA]A1+, withdrawn	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+

Complexity level of the rated instrument:

ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website www.icra.in

Annexure-1: Instrument Details

ISIN No.	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs. crore)	Current Rating and Outlook
-	Fund-based / Non-fund Based Limits	NA	NA	NA	500.0	[ICRA]AA+ (Stable)
-	Fund-based / Non-fund Based Limits	NA	NA	NA	-	[ICRA]A1+, withdrawn

Source: Dr. Reddy's Laboratories Ltd

Annexure-2: List of entities considered for consolidated analysis

Company Name	Ownership	Consolidation Approach
Dr. Reddy's New Zealand Limited	100.0%	Full Consolidation
Dr. Reddy 's Laboratories (Australia) Pty. Limited	100.0%	Full Consolidation
Dr. Reddv's Laboratories (Pro rietary) Limited	100.0%	Full Consolidation
Dr. Reddy's Venezuela, C.A.	100.0%	Full Consolidation
Dr. Reddy 's Laboratories, Inc.	100.0%	Full Consolidation
Promius Pharma, LLC	100.0%	Full Consolidation
Dr. Reddy's Laboratories Louisiana, LLC	100.0%	Full Consolidation
Reddy Pharma Italia S.R.L.	100.0%	Full Consolidation
Dr. Reddy's S.R.L.	100.0%	Full Consolidation
Reddy Pharma Iberia SA	100.0%	Full Consolidation
Dr. Reddy's Farmaceutica Do Brasil Ltda.	100.0%	Full Consolidation
Dr. Reddy's Laboratories (UK) Limited	100.0%	Full Consolidation
Dr. Reddy's Laboratories (EU) Limited	100.0%	Full Consolidation
Chirotech Technology Limited	100.0%	Full Consolidation
000 Dr. Reddy's Laboratories Limited	100.0%	Full Consolidation
Dr. Reddy's Laboratories Romania S.R.L.	100.0%	Full Consolidation
Reddy Holding GmbH	100.0%	Full Consolidation
beta Institut gemeinnlitzige GmbH	100.0%	Full Consolidation
betapharm Arzneimittel GmbH	100.0%	Full Consolidation
Lacock Holdings Limited	100.0%	Full Consolidation
Reddy Netherlands B.V.	100.0%	Full Consolidation
Reddy Antilles N.V.	100.0%	Full Consolidation
Dr. Reddy's Laboratories SA		
Dr. Reddy's Laboratories International SA (Merged with Dr. Reddy's Laboratories SA w.e.f. June 28, 2019)	100.0%	Full Consolidation
Industrias Quimicas Falcon de Mexico, S.A. de CV	100.0%	Full Consolidation
Aurigene Discovery Technologies (Malaysia) Sdn. Bhd.	100.0%	Full Consolidation
Dr. Reddy's Laboratories New York, Inc	100.0%	Full Consolidation
Dr. Reddy's Laboratories LLC	100.0%	Full Consolidation
Dr. Reddy's Research and Development B.V. (formerly Octoplus B.V.)	100.0%	Full Consolidation
Dr. Reddy's Laboratories Canada Inc.		
Dr. Reddy's Singapore Pte. Limited (stroked off w.e.f. June 4, 2019)		
Dr. Reddy's Laboratories S.A.S.	100.0%	Full Consolidation

Company Name	Ownership	Consolidation Approach
Aurigene Discovery Technologies, Inc.	100.0%	Full Consolidation
Dr. Reddy's Laboratories B.V. (Formerly known as Eurobridge Consulting B.V.)	100.0%	Full Consolidation
OOODRS LLC	100.0%	Full Consolidation
Dr. Reddy's Laboratories Japan KK	100.0%	Full Consolidation
Reddy Pharma SAS	100.0%	Full Consolidation
Dr Reddy's Laboratories Kazakhstan LLP	100.0%	Full Consolidation
Dr. Reddy's (WUXI) Pharmaceutical Co. Limited	100.0%	Full Consolidation
Dr. Reddy's Laboratories Chile SP A.	100.0%	Full Consolidation
Dr. Reddy's Laboratories Malaysia Sdn.Bhd.	100.0%	Full Consolidation
Dr. Reddy's Laboratories Taiwan Limited	100.0%	Equity Method
Dr. Reddy's Laboratories Philippines Inc.	100.0%	Full Consolidation
Dr. Reddy's Laboratories (Thailand) Limited	100.0%	Full Consolidation
Aurigene Discovery Technologies Limited	100.0%	Full Consolidation
DRL Impex Limited	100.0%	Full Consolidation
Dr. Reddy's Bio-Sciences Limited	100.0%	Full Consolidation
Idea2Enterprises (India) Private Limited	100.0%	Full Consolidation
Cheminor Investments Limited	100.0%	Full Consolidation
Regkinetics Services Limited (Formerly known as Dr. Reddy's Pharma SEZ	100.0%	Full Consolidation
Imperial Credit Private Limited	100.0%	Full Consolidation
Aurigene Pharmaceutical Services Limited (from September 16, 2019)	100.0%	Full Consolidation
Joint Ventures		
Kunshan Rotam Reddy Pharmaceutical Co. Limited	50.0%	Equity Method
DRANU LLC	26.0%	Equity Method
DRES Energy Private Limited	51.3%	Equity Method
Other consolidating entities*		
Cheminor Employees Welfare Trust	-	Full Consolidation
Dr. Reddy's Research Foundation	-	Full Consolidation

**The company does not have any equity interests in these entities, but has significant influence or control over it*

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ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

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