September 15, 2017

Dr. Reddy's Laboratories Limited

Summary of rated instruments

Instrument*	Rated Amount (in Rs. crore)	Rating Action
Long-term, fund-based / non-fund based limits	100.0	[ICRA]AA+ (stable); assigned
Short-term, fund-based / non-fund based limits	300.0 (revised from 400.0)	[ICRA]A1+; re-affirmed

*Instrument details are provided in Annexure-1

Rating action

ICRA has assigned a long-term rating of [ICRA]AA+ (pronounced ICRA double A plus)[1] to the Rs. 100.00 crore[2] long-term, fund-based / non-fund based bank facilities of Dr. Reddy's Laboratories Limited ('DRL' or 'the company'). ICRA has also re-affirmed the short-term rating of [ICRA]A1+ (pronounced ICRA A one plus) assigned to the Rs. 300.0 crore (revised from Rs. 400.0 crore) short-term, fund-based / non-fund based bank facilities of DRL.

Rationale

The ratings take into account the company's diversified revenue mix, integrated presence across the value chain, healthy product pipeline and strong financial profile. Although the pace of revenue and profit growth of DRL witnessed moderation during FY2017 and Q1 FY2018, ICRA believes the company's increasing focus on limited competition niche products, injectables and biosimilars would provide fillip to its revenues in the medium term given its strong research and development (R&D) capabilities. As on June 30, 2017, DRL had 97 abbreviated new drug applications (ANDAs) and 2 new drug applications (NDAs) pending approvals from the US Food and Drug Administration (USFDA). The ratings also take into consideration the strong financial profile of the company, as evinced by its healthy profitability levels, robust return indicators and strong liquidity position, supported by sizeable cash balances.

ICRA notes that the price erosions from competitive pressure on key products such as valganciclovir, decitabine and azacitidine, loss of sales to Mc Neil Consumer Healthcare following conclusion of supply arrangements, channel consolidation in the US, and supply constraints following regulatory issues at DRL's manufacturing sites in light of the warning letters issued by the USFDA for two API manufacturing facilities at Srikakulam (Andhra Pradesh) and Miryalaguda (Telengana) and the formulations manufacturing facility at Duvvada (Andhra Pradesh) have impacted financial performance in FY2017. The company thus reported YoY de-growth of ~9% and a muted YoY growth of ~2.7% in operating income in FY2017 and Q1 FY2018, respectively, due to lack of limited competition product launches during the period. DRL's domestic formulations business also witnessed de-growth of ~10% in Q1 FY2018, in line with the industry trend, due to channel de-stocking following the goods and services tax (GST) rollout. The above resulted in a decline in operating profit margin to 17.5% during FY2017 and further down to 10.7% during Q1 FY2018. The operating profit margin in FY2017 was also impacted by higher level of repairs and maintenance charges incurred at some of the manufacturing facilities. Furthermore, the regulatory issues at some of the facilities have resulted in incremental provision of inventory built-up in anticipation of new product launches that failed to materialise (Aloxi and Gleevec) and failure to supply penalties due to supply disruption. ICRA, however, notes the receipt of the establishment inspection report for the Miryalguda (Telangana) facility in July 2017. However, the

[1] *For complete rating scale and definitions, please refer to ICRA's website www.icra.in or other ICRA Rating Publications*

[2] *100 lakh = 1 crore = 10 million*

German regulator did not renew the good manufacturing practise (GMP) compliance certificate in respect of the DRL's formulations manufacturing Unit-2 in Bachupally, Hyderabad in August 2017. Furthermore, DRL has also received six major observations post inspection of the Duvvada (Andhra Pradesh) facility from the German regulator in September 2017. The timely resolution of the warning letters at two of its facilities and Form 483 at one of its facilities is critical for the company's revenue growth.

Aided by strong cash flow generation, DRL's credit metrics remain strong, though moderated over the past one year. 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 also notes the recent class action lawsuit filed by a law firm on behalf of shareholders alleging that the company misled investors in connection with a warning letter from the USFDA dated November 06, 2015 and a letter from Regierung von Oberbayern in Germany, dated August 10, 2017 causing them to lose money on their investments. ICRA will continue to monitor developments in this regards.

Key rating drivers

Credit strengths

- **Strong and well-diversified business model supported by branded formulations business (in India and regulated markets), generic business (with leadership position in certain segments) and backward integration in active pharmaceutical ingredients (APIs)**
- **Well diversified geographic mix, with a strong presence in key generic markets globally –** DRL has a presence in both emerging and developed generics markets, with North America and Europe together contributing ~50% to total sales in FY2017.
- **Pipeline of limited competition products or complex generics for the US generic market indicates good opportunity if the issues related to warning letters are timely resolved -** The company has launched ten and four products in the US in FY2017 and Q1 FY2018, respectively, and has several niche opportunities in the pipeline, including those acquired from Teva Pharmaceuticals in FY2016. Near-term US revenue build up hinges on a number of approvals, including among others, gAloxi, gSubaxone, gCopaxone and gNuvaring. It is critical for DRL to timely resolve the warning letters and receive USFDA approvals on time.
- **Domestic formulations business growth supported by integration of brands acquired from UCB SA –** DRL's domestic formulations business witnessed YoY growth of 9% in FY2017, supported by revenues from new products launches, and the integration of the 20 brands acquired from UCB SA in June 2015. The same, however, reported YoY de-growth of ~10% in Q1 FY2018 following channel de-stocking resulting from transition to GST regime. The revenue from domestic market is, however, expected to improve on the back of improvement in productivity, new product launches (including biosimilars) and focus on brand building.
- **Diversified product portfolio with a large number of product filings across the globe -** DRL filed 26 ANDAs in FY2017 and two in Q1 FY2018. As on June 30, 2017, DRL had 258 cumulative filings (255 ANDAs, three NDAs), of which 99 (97 ANDAs, two NDAs) are pending for approval. Of these 59 are para IV filings with 26 having first to file (FTF) status.
- **Strong R&D capabilities supporting development of a strong generic product pipeline (including FTFs, complex technology products and biosimilars) in developed markets**
- **Moderate debt levels resulting in comfortable capital structure and healthy coverage indicators –** DRL's total consolidated debt as on March 31, 2017, stood at Rs. 4,918.0 crore, resulting in comfortable gearing of 0.40 time. The increase in debt has been due to incremental working capital requirements. The coverage indicators, athough moderated in FY2017, stand comfortable as reflected by OPBITDA/Interest of 39.1 times and NCA/Total Debt of 40%.

Credit weaknesses

- **Moderation in profitability in FY2017 and Q1 FY2018 amid continuing and increased competition, along with a challenging pricing environment for the US -** The operating profit margin of DRL declined to 17.5% in FY2017 and further down to 10.7% Q1 FY2018. This took place following the pricing pressures in the US, arising from intense competition among manufacturers, new entrants to the market and supply channel consolidations.
- **Delays in resolution of warning letters issued to the Srikakulam API facility and Duvvada formulations facility, and Form 483 issued to the Bachupally formulations facility; if rectifications are not undertaken speedily, this may aggravate supply issues -** The pace of ANDA approvals of the company has continued to be weak, attributed to warning letters issued to the Srikakulam (Andhra Pradesh) and Duvvada (Andhra Pradesh) facilities as well as Form 483 issued to the Bachupally facility. The firm's increasing focus on complex products was another factor.
- **Management strategy of R&D focus on limited competition, proprietary products and biosimilars to result in higher R&D cost**
- **Increased focus on cost containment by Governments in various regulated markets may continue to limit profitability of generic players**

Analytical approach: For arriving at the ratings, ICRA has taken a consolidated view of DRL.

Links to applicable criteria:
Rating Methodology for Pharmaceutical Industry
Corporate Credit Rating Methodology

About the company:
Dr. Reddy's Laboratories Limited 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 company on December 6, 1985 and listed on the Bombay Stock Exchange and (BSE) the National Stock Exchange (NSE) in August 1986 as well as on the New York Stock Exchange (NYSE) on April 11, 2001. As on June 30, 2017, the promoters and promoter group held 26.78% stake in the company.

The company's manufacturing facilities are located at India, the UK, US, and Mexico, and an R&D centre is located in Telangana (India). DRL has a nine-member Board, comprising two promoter directors and seven independent directors, each an eminent personality in the field of finance, strategic consulting, science and economics.
For the 12-month period ended March 31, 2017, DRL (consolidated) reported a profit after tax (PAT) of Rs. 1,257.2 crore[3] on an operating income (OI) of Rs. 14,196.1 crore[4], as against a PAT of Rs. 2,107.7 crore on an OI of Rs. 15,568.3 crore for the 12-month period ended March 31, 2016.

For the three-month period ended June 30, 2017, DRL (consolidated) reported a PAT of Rs. 56.8 crore on an OI of Rs. 3,333.2 crore.

[3,4] *Before minority interest*

Key Financial Indicators (Audited)

	FY2016	FY2017
Operating Income (Rs. crore)	15,568.3	14,196.1
PAT (Rs. crore)*	2,107.7	1,257.2
OPBDIT/ OI (%)	25.75%	17.46%
RoCE (%)	20.48%	10.21%
Total Debt/ TNW (times)	0.27	0.40
Total Debt/ OPBDIT (times)	0.84	1.98
Interest coverage (times)	48.54	39.11
NWC/ OI (%)	25%	29%

**Before minority interest*

OI: Operating Income; PAT: Profit after Tax; OPBDIT: Operating Profit before Depreciation, Interest, Taxes and Amortisation; ROCE: PBIT/Avg. (Total Debt + Tangible Net-Worth + Deferred Tax Liability - Capital Work - in Progress); NWC: Net Working Capital

Status of non-cooperation with previous CRA: Not applicable

Any other information: Not applicable

Rating history for last three years:
Table:

S. No.	Instrument	Type	Current Rating (FY2018)			Chronology of Rating History for the past 3 years		
			Amount Rated (Rs. crore)	Date & Rating		Date & Rating in FY2017	Date & Rating in FY2016	Date & Rating in FY2015
				September 2017	September 2017	-	March 2016	January 2015
1	Fund-based / non-fund based bank facilities	Short -term	300.0	[ICRA]A1+	[ICRA]A1+	-	[ICRA]A1+	[ICRA]A1+
2	Fund-based / non-fund based bank facilities	Long-term	100.0	[ICRA]AA+ (stable)	-	-	-	-

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

Instrument	**Date of Issuance / Sanction**	**Coupon Rate**	**Maturity**	**Amount Rated (Rs. crore)**	**Current Rating and Outlook**
Fund-based / non-fund based bank facilities	-	-	-	100.0	[ICRA]AA+ (Stable)
Fund-based / non-fund based bank facilities	-	-	-	300.0	[ICRA]A1+

Source: Dr. Reddy’s Laboratories Limited

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About ICRA Limited:

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.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

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