June 25, 2020

Dr. Reddy's Laboratories Ltd.: Rating re-affirmed

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	500.0	500.0	[ICRA]AA+ (Stable); re-affirmed
Total	**500.0**	**500.0**	

**Instrument details are provided in Annexure-1*

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 and cash surplus (excess of cash and liquid investments over debt) status as of March 31, 2020. 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 March 31, 2020, DRL had 99 abbreviated new drug applications (ANDAs), of which two are filed under the 505(b)(2) route, 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. 2,606 crore and undrawn working capital limits (standalone) of Rs.2,624 crore as on March 31, 2020.

After witnessing a modest growth of 1% in operating income (OI) in FY2018, the revenue-growth rate for DRL improved over FY2019 and FY2020, with a YoY growth rate of 8% and 13%, respectively. This was led by the improved revenue growth in India, Europe and emerging markets. DRL also reversed its downward growth trajectory in the North America Generics (NAG) market, which reported modest YoY growth of 8% in FY2020 led by new product launches, though the overall business environment remained competitive owing to the faster pace of ANDA approvals. The revenue growth during FY2020 was also supported by a one-time income of Rs. 748.6 crore on account of the sale of the US and select territory rights for two of DRL's neurology brands (under the proprietary products division). Adjusting for the same, the revenue growth stands at around 10% for FY2020.

DRL's operating profit margins (OPM) also improved to 24% in FY2020 (adjusting for the one-time income from sale of neurology brands, OPM stands at 20.7%), from 16.5% in FY2018, aided by improved revenue growth and several cost rationalisation initiatives undertaken by the company. However, it remained lower than the earlier levels, due to lower limited competition launches as well as continued price erosion witnessed in the base business in the US. Despite the increased non-operating income (largely on account of Rs.345.7 crore of income received pursuant to a settlement agreement entered into for gRevlimid towards damages under Section 8 of the Canadian Patented Medicines (Notice of Compliance) Regulations), the net profits were adversely impacted in FY2020 due to the Rs. 1,676.7 crore of impairment of intangibles undertaken by DRL. Of this, Rs 1,113.7 crore pertained to gNuvaring- the ANDA of which was acquired from TEVA for Rs. 14.26 billion in FY2016. DRL had also taken an impairment charge of Rs 355.1 crore on three product related intangibles acquired from TEVA in August 2016 (viz., Ramelteon, Tobramycin and Imiquimod). Consequent to the above, the net profits were adversely impacted in FY2020, with DRL reporting net profit margin (NPM) of 11.2% in FY2020 vis-a-vis 12.3% in FY2019. The return on capital employed (ROCE) stood at 12.4 % for FY2020 vis-a-vis 16.4% for FY2019.

DRL's product pipeline for the US remains strong, though the company is facing delays in the launch of gCopaxone, which was earlier expected to be launched in, H2 CY2019. The company also has successfully resolved all its pending regulatory non-compliances and currently its plants, either have a Voluntary Action Indicated (VAI) or a No Action Indicated (NAI) status from the USFDA. DRL's ability to maintain a healthy product portfolio in the US markets as well as improve its market share in key products and geographies are critical for the revenue and profitability growth of the company and are the key rating sensitivities.

Being part of the essential services, the pharmaceutical segment and hence DRL, remained operational during the period of the lockdown following the COVID-19 pandemic. DRL however, faced some logistics challenges during the initial period of the lockdown, which were subsequently resolved. There has been a slowdown in the demand in the domestic markets owing to reduced discretionary visits to doctors, thereby impacting the prescriptions. The impact of the same is however, expected to be more than offset by the intergration of the recently acquired Wockhardt business into DRL (w.e.f June 10, 2020), comprising portfolio of 62 brands in multiple therapy areas such as respiratory, neurology, dermatology, gastroenterology, pain and vaccines. The transaction value for the same is upto Rs. 1,850 crore[1] and is expected to be funded through internal accruals.

The profitability of the company remains vulnerable to foreign exchange fluctuations on account of its foreign operations as well as foreign currency borrowings, though the company has a defined hedging policy in place. The rating also factors in the exposure of the company's operations to regulatory risks, 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 as well as the other on-going product-related litigations. 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 and new product launches.

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 ~44% to its total sales in 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 active pharmaceutical ingredients (APIs). Around 50% of the global generics segment sales are from its vertically integrated APIs.

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[1] *Includes holdback amount of Rs. 300 crore (which shall be released as follows: a) If the revenue from sales of the acquired products during the 12 months post-closing exceeds Rs. 480 crore, DRL will be required to pay to Wockhardt, an amount equal to two times the amount by which the revenue exceeds Rs. 480 Crores, subject to the maximum of the Holdback Amount.*

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 – The company has been investing significantly in R&D (9% of its net sales in FY2020), 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 oncology as well as biosimilars.

Strong pipeline of limited competition products for the US generic market – The company launched 27 products in the US in FY2020 and has a strong product pipeline. As on March 31, 2020, DRL had 99 ANDAs, of which two are 505 b(2) filings, pending approval from the USFDA. The near-term US revenue build-up hinges on the company's ability to maintain a 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.

Healthy financial profile characterised by robust credit metrics and strong liquidity supported by sizeable cash balances and liquid investments – DRL's financial profile is robust, characterised by Total Debt/ OPBDITA of 0.5 times and interest coverage of 42.8 times for FY2020. It also turned cash surplus as of March 2020, with cash and liquid investments of Rs 2,606.8 crore as against total debt of Rs.2,210.2 crore as of March 31, 2020.

Credit challenges

Constrained, though improving, profitability (excluding one-time sale proceeds of commercial proprietary products) over the last two years due to few limited competition product launches in the US – 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 adjusted OPM (excluding one-time sale proceeds of commercial proprietary products) improved to 20.7% in FY2020, aided by improved revenue growth and several cost rationalisation initiatives undertaken by the company. However, it remains lower than the earlier levels, due to fewer limited competition launches as well as the continued price erosion being witnessed in the base business in the US. Timely launch of the limited competition products and the company's ability to garner a meaningful market share within a reasonable time frame remain critical.

On-going industry-wide investigations, pending resolution of product litigations as well as exposure to regulatory risks-The rating 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 as well as the on-going product litigation. The operations of the company also remain exposed to regulatory risks, arising out of the greater scrutiny by regulatory agencies including the USFDA. ICRA notes that the company has successfully resolved all its pending regulatory non-compliances and currently its plants, either have a VAI or a NAI status from the USFDA.

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. 2,606 crore and undrawn working capital limits (standalone) of Rs. 2,624 crore as on March 31, 2020. The cash flow generation of the company is also expected to remain strong over the medium term supported by improvement in revenue growth across the major geographies.

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 any weakening in the company's profitability. Any regulatory non-compliance issued to DRL for its products and/or manufacturing facilities, which may impact 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/litigations would remain an event risk, and the impact of the same 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 March 31, 2020, the company had 52 subsidiaries, three joint ventures and three 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 March 31, 2020, the promoters and the promoter Group held 26.75% 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 segments—global generics (accounting for 79% of the revenues of the company in FY2020), pharmaceutical services and active ingredients (accounting for 15% of the revenues of the company in FY2020) and proprietary products and others (accounting for 7% of the revenues of the company in FY2020). The major therapeutic areas of focus for the company include central nervous system, gastro-intestinal, cardiovascular, diabetology, oncology, pain management and dermatology, with the US, India, Europe, Russia and the Commonwealth of Independent States (CIS) countries being the major markets.

DRL, currently, has eight API-manufacturing facilities, which are USFDA approved (six in India, one in Mexico and one in Mirfield, United Kingdom) and 13 formulations manufacturing facilities (including the ones through JVs). In addition, it has one biologics facility in India and several technology development and R&D centres in India and across the globe. DRL has a 12-member Board, comprising two promoter directors and 10 independent directors, each an eminent personality in the field of finance, strategic consulting, science and economics.

Key financial indicators (audited, consolidated)

	FY2019	FY2020
Operating Income (Rs. crore)	15,494.0	17,581.0
PAT (Rs. crore)	1,906.2	1,969.9
OPBDIT/ OI (%)	20.8%	24.0%
RoCE (%)	16.4%	12.4%
Total Outside Liabilities/ TNW (times)	0.6	0.4
Total Debt/ OPBDIT (times)	1.2	0.5
Interest Coverage (times)	36.3	42.8
DSCR	31.7	7.8

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for last three years:

	Instrument	Current Rating (FY2021)				Chronology of Rating History for the Past 3 years			
		Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	Date & Rating	Date & Rating	Date & Rating in FY2019	Date & Rating in FY2018	
					25-Jun-19	08-Nov-19	14-Dec-18	15-Sep-17	1-Sep-17
1	Fund-based / Non-fund Based Limits	Long-term	500.0	-	[ICRA]AA+ (Stable)	[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+

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)

Source: Dr. Reddy's Laboratories Ltd.

Annexure-2: List of entities considered for consolidated analysis

Company Name	Ownership	Consolidation Approach
Aurigene Discovery Technologies Limited	100.0%	Full Consolidation
Cheminor investments Limited	100.0%	Full Consolidation
Dr. Reddy's Bio-Sciences Limited	100.0%	Full Consolidation
Dr. Reddy's faITTJaceutica Do Brasil Ltda.	100.0%	Full Consolidation
Dr. Reddy's Laboratories SA	100.0%	Full Consolidation
ldea2Enterprises (India) Private Limited	100.0%	Full Consolidation
Imperial Credit Private Limited	100.0%	Full Consolidation
Industrias Quimicas Falcon de Mexico, S.A.de C.V.	100.0%	Full Consolidation
Reddy Antilles N.V. (Liquidated during the year)	100.0%	Full Consolidation
Regkinetics Services Limited	100.0%	Full Consolidation
Aurigene Discovery Technologies (Malaysia) SDN BHD	100.0%	Full Consolidation
Aurigene Discovery Technologies rnc.	100.0%	Full Consolidation
Aurigene Pharmaceuticals Services Limited	100.0%	Full Consolidation
Beta Institut gemeinniitzige GmbH	100.0%	Full Consolidation
Betapharm Arzneimittel GmbH	100.0%	Full Consolidation
Chirotech Technology Limited	100.0%	Full Consolidation
DRL Impex Limited	100.0%	Full Consolidation
Dr. Reddy's Laboratories (Australia) Pty. Limited	100.0%	Full Consolidation
Dr. Reddy's Laboratories Canada, Inc.	100.0%	Full Consolidation
Dr. Reddy's Laboratories Chile SP A.	100.0%	Full Consolidation
Dr. Reddy's Laboratories (EU) Limited	100.0%	Full Consolidation
Dr. Reddy's Laboratories Inc.	100.0%	Full Consolidation
Dr. Reddy's Laboratories International SA	100.0%	Full Consolidation
Dr. Reddy's Laboratories Japan KK	100.0%	Full Consolidation
Dr. Reddy's Laboratories Kazakhstan LLP	100.0%	Full Consolidation
Dr. Reddy's Laboratories LLC	100.0%	Full Consolidation
Dr. Reddy's Laboratories Louisiana LLC	100.0%	Full Consolidation
Dr. Reddy's Laboratories Malaysia Sdn. Bhd.	100.0%	Full Consolidation
Dr. Reddy's Laboratories New York, Inc.	100.0%	Full Consolidation
Dr. Reddy's Laboratories Philippines Jnc. (from 9 May 2018)	100.0%	Full Consolidation
Dr. Reddy's Laboratories (Proprietary) Limited	100.0%	Full Consolidation
Dr. Reddy's Laboratories Romania S.R.L.	100.0%	Full Consolidation
Dr. Reddy's Laboratories SAS	100.0%	Full Consolidation
Dr. Reddy's Laboratories Taiwan Limited	100.0%	Full Consolidation
Dr. Reddy's Laboratories Tennessee, LLC (till I October 2018)	100.0%	Full Consolidation
Dr. Reddy's Laboratories (Thailand) Limited (from 13 June 2018)	100.0%	Full Consolidation

Company Name	Ownership	Consolidation Approach
Dr. Reddy's Laboratories (UK) Limited	100.0%	Full Consolidation
Dr. Reddy's Research and Development B.V.	100.0%	Full Consolidation
Dr. Reddy's Singapore PTE Limited (liquidated during the year)	100.0%	Full Consolidation
Dr. Reddy's Sri	100.0%	Full Consolidation
Dr. Reddy's New Zealand Limited	100.0%	Full Consolidation
Dr. Reddy's (WUXJ) Pharmaceutical Co. Limited	100.0%	Full Consolidation
Dr. Reddy's Venezuela, C.A.	100.0%	Full Consolidation
Eurobridge Consulting B.V.	100.0%	Full Consolidation
Lacock Holdings Limited	100.0%	Full Consolidation
OOO Dr. Reddy's Laboratories Limited	100.0%	Full Consolidation
OOO DRS LLC	100.0%	Full Consolidation
Promius Pharma LLC	100.0%	Full Consolidation
Reddy Holding GmbH	100.0%	Full Consolidation
Reddy Netherlands B.V.	100.0%	Full Consolidation
Reddy Pharma Iberia SA	100.0%	Full Consolidation
Reddy Pharma Italia S.R.L	100.0%	Full Consolidation
Reddy Pharma SAS	100.0%	Full Consolidation
Joint ventures		
DRANU LLC	26.0%	Equity Method
DRES Energy Private Limited	51.3%	Equity Method
Kunshan Rotam Reddy Pharmaceutical Company Limited	50.0%	Equity Method
Other consolidating entities*		
Cheminor Employees Welfare Trust	-	Full Consolidation
Dr. Reddy's Employees ESOS Trust (from 27 July 2018)	-	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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