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REDDY TO EXPERIMENT

With the succession issue settled, it is Version 2.0 for Hyderabad-based DRL — fewer geographies, niche products and a collaborative R&D approach

By P. B. Jayakumar

G.V. PRASAD
CHAIRMAN & CEO, DR REDDY'S LABORATORIES

'EARLIER, WE WERE A TABLETS-AND-CAPSULES COMPANY. WE INVEST MORE IN DEVELOPING PRODUCTS NOW'

Photographs by B.K. Ramesh

O N THE TOP FLOOR OF DR REDDY'S Laboratories' (DRL) corporate office at Banjara Hills in Hyderabad, the plush chamber of founder-chairman, K. Anji Reddy, remains vacant a year after his death. The new chairman and chief executive officer, G. V. Prasad (his son-in-law), and son, K. Satish Reddy, vice-chairman and managing director, continue to work from relatively smaller adjacent offices.

This does not mean that the present-day DRL is the same company that Anji Reddy built over three decades. Its nature and business profile have undergone a sea change in the last five years; revenues and profits have been at an unprecedented high for the past two years, helping the company put the stagnant business phase of the preceding three years behind it. DRL is more focused now; it no longer operates across several geographies.

But the question is: Will DRL — the second largest Indian drug maker (after the Sun Pharma-Ranbaxy Laboratories merger) in terms of revenues and market capitalisation — be able to maintain its growth momentum, having reinvented and transformed its business approach over the past few years? Will its focus on less than a dozen countries make its business more risky? And, lastly, whether the company is still a soft target for acquisition?

To answer these, one needs to step back in time. The succession issue at DRL became a hot topic of speculation during the company's annual general

K. SATISH REDDY
VICE-CHAIRMAN & MD, DR REDDY'S LABORATORIES

'WE'VE MADE LOTS OF CHANGES IN THE RECENT PAST — THE PORTFOLIO AND THE WAY WE WANTED TO GROW IN INDIA'

meeting (AGM) in Hyderabad in 2012 when Anji Reddy's absence fuelled rumours of a management reshuffle for the first time in DRL's history. Sections of the media and shareholders wondered whether it would be Satish Reddy or Prasad at the helm of affairs.

The Succession

Prasad, who is married to Anji Reddy's daughter, G. Anuradha, has long been associated with DRL. He joined the board of the company back in 1986. In 2001, he became vice-chairman and CEO of the company when Hyderabad-based Cheminor Drugs, in which Prasad held the post of managing director, was merged with DRL. A chemical engineer with a degree from the Illinois Institute of Technology and a master's in Industrial Administration from Purdue University in the US, Prasad is seen as the mastermind behind DRL's transformation from a mid-sized pharma company to a global generics player.

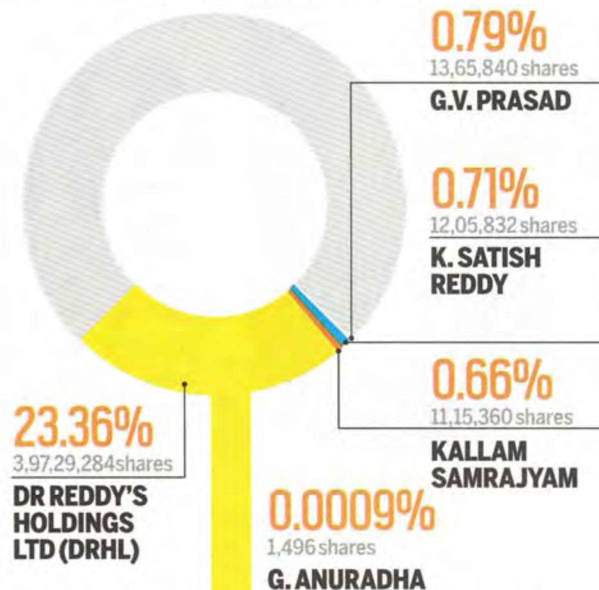
Satish Reddy, a chemical engineer, joined the company in 1993 as executive director after obtaining a master's in medicinal chemistry from Purdue University. The 46-year-old was elevated as managing director in 1997 and was mainly responsible for DRL's foray into branded generics and its growth in emerging markets.

Long before speculation became rife, Anji Reddy and his family had initiated the succession process. On 26 September 2011, Prasad, on behalf of other family members, moved an application with the Securities and Exchange Board of India (Sebi) for the acquisition of the promoter holding company of DRL — Dr Reddy's Holdings Limited (DRHL) — by another entity called APS Trust. The application also sought exemption from an open offer trigger, on the reasoning that the acquisition was a private family arrangement intended to streamline succession. Besides, the total shareholding of the group was not going to change.

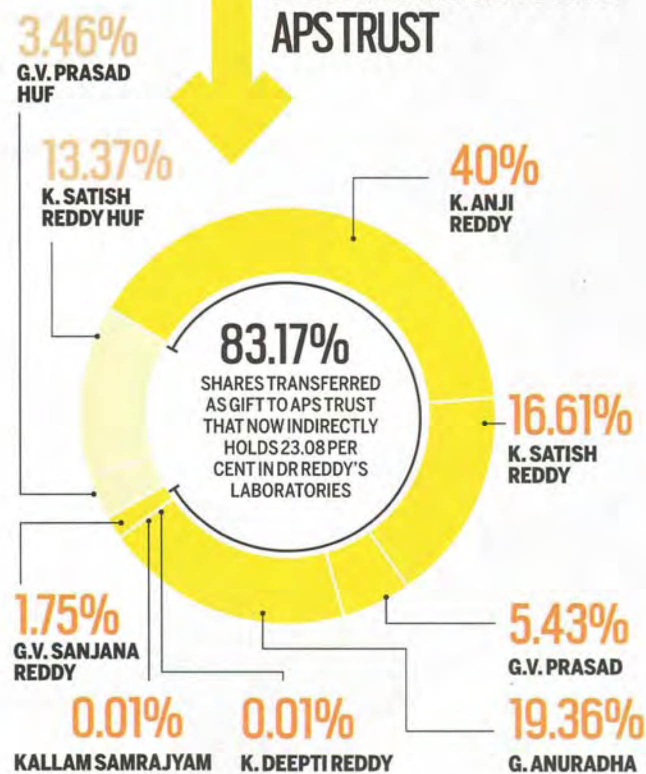
"The panel is of the view that the indirect acquisition for which exemption is sought will not affect or prejudice the interests of public shareholders of the target company in any manner. Further, there will be no change of control, or shareholding of the target company pursuant to the aforesaid indirect acquisition," said a Sebi order dated 3 May 2012, allowing such a transaction for the first time.

As on 30 June 2011, the total shareholding of the promoter group was 25.61 per cent in the company, mainly controlled by DRHL. Anji Reddy was the biggest shareholder in DRHL, with a 40 per cent stake, and the other major shareholders were Satish Reddy (16.61 per cent), Prasad (5.43 per cent), Anuradha (19.36 per cent) and

PROMOTER SHAREHOLDING IN DR REDDY'S LABORATORIES



DRHL SHAREHOLDING PRIOR TO TRANSFER TO APS TRUST



SOURCE: SEBI & BSE

Satish Reddy HUF (13.37 per cent).

The beneficiaries of the APS Trust were listed as Anji Reddy, Satish Reddy, Anuradha, Prasad, daughter-in-law Deepti Reddy and their bloodline descendants (Reddy family).

A month after the Sebi order, Anji Reddy transferred 39.99 per cent of his stake (out of 40 per cent) in DRHL to APS Trust, retaining just about 100 shares. Other promoter members also transferred their shareholding to the new trust. While Satish Reddy transferred 16.61 per cent, retaining his 13.37 per cent HUF stake, Prasad transferred 5.43 per cent, keeping his 3.46 per cent HUF stake.

As of December 2013, DRHL, now owned by APS Trust, held 23.36 per cent in DRL, besides Satish Reddy owning 0.71 per cent, Prasad owning 0.79 per cent and Anji Reddy's wife Kallam Samrajyam owning 0.66 per cent in the company.

"This was an important order from Sebi wherein it granted exemption for direct or indirect acquisition of shares in a listed company by the family trust," says a KPMG note on the deal.

"APS Trust was formed to address the succession issue at DRL, and is in line with how international private companies execute succession plans. The whole transfer was done well before Anji Reddy fell ill," reveals Satish Reddy.

With Prasad becoming chairman and Satish Reddy vice-chairman, the rumours of infighting were put to rest and the succession issue settled. But is DRL still a soft target for acquisition?

The low promoter group holding in DRL — at present it is only 25.52 per cent — is one of the reasons behind such a possibility. Foreign institutional investors (FIIs) own 33.35 per cent in the company. In comparison, the promoters hold 46.75 per cent in Lupin, 74.70 per cent in Wockhardt and Dilip Shanghvi will hold 59 per cent in Sun Pharma after the merger with Ranbaxy.

While Anji Reddy sent out a strong message to quell rumours about some multinationals eyeing the company — "Dr Reddy's Laboratories will not be sold in my lifetime" — Satish Reddy says the chances of a hostile acquisition are unlikely in the case of DRL.

Neither multinationals nor top generic companies will try to buy an entire company for a piece of the business, believes Satish Reddy, noting that the current promoter holding is adequate to dictate resolutions in the event of hostile takeover attempts. "Whether you have 25 per cent or 49 per cent does not matter... Why should a top generic company pay a big premium to get our active pharmaceutical ingredient (API) or US or Russia or India business," he asks.

Shifting Focus

DRL's revenues are mainly dependent on the US market, with about 45 per cent of the its entire generics revenues (Rs 8,256 crore in 2012-13) coming from it. Earlier, the company used to be among the first Indian companies to challenge patents (Para IV certified marketing applications) of multinational drug companies in the US, and thus earn extra revenues from exclusive sales for the first six months since patent expiry. But that aggression has waned; the company now has a focused approach.

"With multinationals now allowing authorised generics and shared exclusivities and with more and more people filing on day one, the attractiveness of the Para IV strategy has gone down," says Satish Reddy.

Therefore, for the last 2-3 years, DRL has been concentrating on limited-competition products, complex generics and high-margin products for the US market.

PHOTOGRAPH: BLOOMBERG

SHIFT IN DRL'S BUSINESS STRATEGY

EARLIER: Aggressive patent challenges in the US
NOW: Select patent challenges on limited-competition and complex generic products, biosimilars

EARLIER: After the US, Europe was a big focus area; acquired Betapharm in Germany
NOW: Europe focus limited to Germany and the UK. Keen to sell proprietary products in Europe to increase profitability

EARLIER: Sold products in nearly 50 countries
NOW: Has exited 30 markets, focus now on the US, Russia & CIS, Venezuela, South Africa, Australia, New Zealand and South-east Asia, besides India

EARLIER: R&D focus on developing new chemical entities (NCE) with an out-licensing model
NOW: Focus on new drug delivery systems, complex generics, biosimilars and proprietary products with both in-house and collaborative research

EARLIER: Ignored Indian market and slipped out of the top 10; a position it enjoyed till the mid-1990s
NOW: Aggressive increase in sales force, divisions and products to boost Indian revenues, wants to grow above industry average

EARLIER: Focused more on API production for in-house requirements
NOW: Attempting to improve customer engagement, delivery time and aggressive global sales

EARLIER: Competed aggressively with multinational innovators for patent challenges
NOW: Partnering with companies like GlaxoSmithKline and Merck Serono for research, development, manufacture and sales in various geographies

EARLIER: More of a tablets-and-capsules company, selling in volumes to generate revenues and profits
NOW: Focus on high-value products such as injectables, biosimilars and branded generics

"Earlier, we were a tablets-and-capsules company. Now, we are investing more in developing products like injectables (contributed 30 per cent of US revenues) and topical products, with a focus on delivery systems, platforms and products, which have barriers to entry and require clinical trials," says Prasad.

The strategy is paying off. About 39 per cent of DRL's consolidated revenues (Rs 11,626.6 crore in 2012-13) came from the US market. The revenues from North America grew by 19 per cent to Rs 3,784 crore during the period, and in the third quarter of FY14, they were at Rs 1,620 crore, a year-on-year growth of 76 per cent.

"The growth in the US will be harder to sustain in the future since customers are consolidating and are fewer in number now," warns Prasad.

Analysts Alok Dalal and Hardick Bora of Motilal Oswal, a financial service provider, say DRL is going to face the challenge of the base effect playing out in the US for the fourth quarter of this year and the next fiscal. "For FY15, the focus will be on ramping up sales in limited-competition products approved in FY14 due to lack of blockbuster launches," they say. The two predict a 10 per cent year-on-year business growth in the US in 2014-15 to $1 billion, but better revenues subsequently.

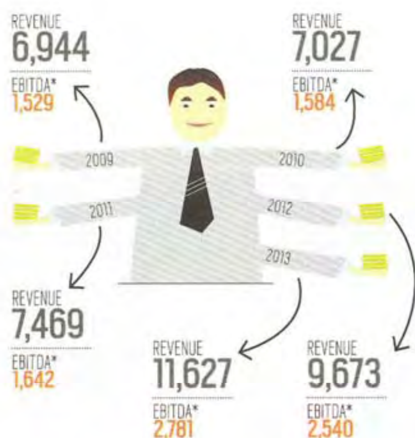
Taking a more optimistic view, analysts with brokerage firm Prabhudas Lilladher, in their Q3 FY14 analysis, say DRL has built a sizable US business on the back of a strong product pipeline of niche and limited-competition products such as Geodon, Lipitor, Toprol XL, Arixtra and Tacrolimus. The company has also developed a strong over-the-counter franchise in the US market. They expect the US business to grow over 21 per cent in the next two years.

"With a healthy pipeline of 64 products awaiting approval in the US, DRL is set for good growth in the US market," say analysts from HDFC Securities in their report for the third quarter of FY14.

But in Europe — the next biggest market for DRL, accounting for 17 per cent of its revenues — the company is not doing as well. Its presence is limited to the UK

PAYING DIVIDEND

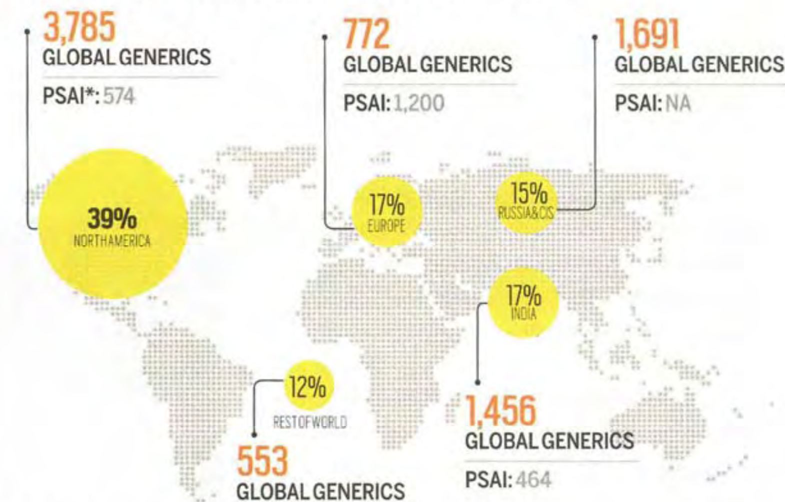
The change in DRL's business model has yielded smart gains over the past two years



FIGURES IN Rs CR; YEAR IS FINANCIAL YEAR
* EARNINGS BEFORE INTEREST, TAX, DEPRECIATION AND AMORTISATION

HEALTHY MIX

The share of North America in DRL's total revenues has grown considerably since the rejig in the business model



% OF TOTAL REVENUES

Graphic by Venkatesulu

FIGURES IN Rs CR ROUNDED OFF; *PHARMA SERVICES AND ACTIVE INGREDIENTS. SOURCE: DRL

and Germany. In the latter, it acquired Betapharm Arzneimittel GmbH in 2006 for $560 million. The company got 9 per cent (Rs 771 crore) of its generics business from Europe in 2012-13, 7 per cent less than the Rs 825 crore (12 per cent) it got the previous year.

In the first three quarters of FY14, the sales of branded formulations in Europe were down 11.7 per cent compared to the corresponding period the previous year. The loss in business was primarily because Germany moved from being a branded generics market to a commoditised, tender-based market. As a result, drug prices in the German market crashed. And, Betapharm turned out to be a bad buy.

"We are going to take our differentiated products to that market so as to increase our profitability," says Prasad, adding that Europe is no longer a focus market for DRL. "We have a new plan for Europe, but the strategy is in the pilot stage. I will talk about it once the results start showing," says Satish Reddy.

Overhauling The Business

In the past, DRL operated like any other generics company — selling drugs across geographies. It, in fact, sold in as many as 50 countries.

"One issue we were facing was too much complexity in operations, dealing with 50-odd countries. Besides, a majority of them were insignificant in their contribution to sales," says Satish Reddy.

So, DRL exited from around 30 countries in favour of a more focused approach. Among emerging markets, Russia and the Commonwealth of Independent States (CIS) are now key areas, with Russia contributing to a majority of its sales. In 2012-13, emerging markets contributed 31 per cent of DRL's global generic sales.

Russia contributed 20 per cent of the overall generic sales last year, with revenues of Rs 1,404 crore, up 27 per cent. The compound annual growth rate (CAGR) in Russia for the past five years has been 25 per cent. "We did not exit Russia when other Indian companies exited that market and that strategy is paying off," says Prasad.

Russia is the tenth largest pharma market in the world. It is worth around $26 billion. Various industry estimates project the market to treble to $75 billion by 2020. DRL — currently the largest Indian company in Russia that imports 70 per cent of its drug requirements — has a share of only 1 per cent of the Russian market.

The company's CIS presence is restricted to Ukraine, Belarus, Kazakhstan and Uzbekistan. In the rest of the world, the major markets for the company are Venezuela, South Africa, Australia, New Zealand and South-east Asia. The revenues from the rest of the world market grew 42 per cent in 2012-13, to Rs 553 crore.

As far as numbers in India are concerned, both Satish Reddy and Prasad admit that the company could have

done better. Back in the 90s, DRL used to be among the top 10 domestic companies. It has slipped in the rankings since. So, the aim is to aggressively build back the Indian business.

DRL launched 24 new products last year and clocked revenues of Rs 1,460 crore, with a sales growth of 13 per cent. The focus areas are oncology, cardiovascular, pain management and gastro-intestinal. "We had to make lots of changes in the past few years — the portfolio, marketing divisions and the way we want to grow in India. Our first attempt is to grow at at least the industry rate," says Satish Reddy.

Another area where DRL wants to improve is its pharmaceutical services and active ingredients (PSAI) business, which contributes 26 per cent of the company's revenues, with 150 products sold in 80 countries.

DRL — the second largest API seller in the world— had revenues of Rs 3,070 crore in 2012-13 with a growth of 29 per cent over the previous year. But the business has declined. The PSAI business went down 15.6 per cent, with revenues of Rs 1,733 crore in the first nine months of 2013-14, compared to the corresponding period last year. The revenues from PSAI for the third quarter also declined by 29 per cent.

BACK IN THE 90s, DRL USED TO BE AMONG THE TOP 10 DOMESTIC COMPANIES. THE AIM IS TO BUILD BACK THE INDIAN BUSINESS AND REACH THAT MARK

"PSAI gross margins declined primarily on the back of fewer launches of molecules and relatively higher overheads," say analysts from Firstcall Research.

The research focus of the company has also changed. Anji Reddy's dream of developing a new chemical entity (NCE) has been shelved. The thrust now is on developing limited-competition products, drug delivery platforms, proprietary products and biosimilars.

DRL is also betting on its partnerships with Merck Serono and GlaxoSmithKline (GSK) Pharmaceuticals.

The deal with Merck Senoro is to co-develop a portfolio of biosimilar compounds in oncology, primarily focused on monoclonal antibodies, including co-development, manufacture and commercialisation of the compounds around the globe. "First, we are looking at a couple of products for the US market," says Prasad.

The alliance with GSK, of 2009 vintage, is to develop and sell select products across emerging markets outside India in fast-growing therapeutic segments. The first products from the collaboration are being readied for launch. The partnership is expected to help DRL earn from the markets it exited, but where GSK has a presence.

A Promising Future

With the transformation in the business, both Satish Reddy and Prasad hope DRL will continue its robust growth in the near term. They believe the next wave of growth will be through proprietary products.

The focus is to improve profitability of the company. For the first three quarters of 2013-14, net revenues were Rs 9,736 crore, 17.5 per cent more than that in the the corresponding period last year, with a profit after tax (PAT) of Rs 1,100 crore, a rise of 50.9 per cent over the previous year. Analysts with Firstcall Research believe the company's PAT margins will grow from the current 14.34 per cent of revenues to 16.68 per cent by FY15.

"We expect DRL's revenue and PAT to witness a CAGR of 7 per cent and 29 per cent over FY13-15," says an analysis by India Infoline, a brokerage firm. Firstcall Research analysts predict net sales and PAT of the company to grow at a CAGR of 16 per cent and 21 per cent, respectively, between 2012 and 2015.

The biggest challenge to DRL remains its main market— the US. "Consolidation in the chain, between wholesalers and retailers, is going to put pressure on manufacturers and profitability in the US," says Satish Reddy. Focusing on fewer markets is also risky. "Lack of GDP growth in emerging markets is a concern," adds Satish Reddy, saying that scaling up business will be key. "We are looking to launch 20-25 generic products every year, whether in-house or from collaborations."

Superior revenue mix coupled with competent R&D makes DRL one of the best bet in the pharma space, says an industry observer. "We believe that the company will be a key beneficiary of large patent expiries taking place in the US and Europe and strong growth movements in branded generic markets such as Russia, Latin America and India," say analysts from Prabhudas Lilladher.

Prasad says once biosimilars, injectables and other proprietary limited-competition products get going, they'll be able maintain growth in future.

Whether that happens or not, analysts and investors believe the company is heading in the right direction. BW

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