India Ratings & Research
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India Ratings Assigns Dr. Reddy's Laboratories' CP 'IND A1+'; Affirms Existing Ratings; Limits Enhanced

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India Ratings and Research (Ind-Ra) has taken the following rating actions on Dr. Reddy's Laboratories Limited (DRL):

Instrument Type	Date of Issuance	Coupon Rate	Maturity Date	Size of Issue (million)	Rating/Outlook	Rating Action
Long-Term Issuer Rating	-	-	-	-	IND AA+/Stable	Affirmed
Fund-based working capital limits	-	-	-	INR100 (increased from INR80)	IND AA+/Stable/IND A1+	Long-term rating affirmed; short-term assigned
Non-fund-based working capital limits	-	-	-	INR1,200 (increased from INR920)	IND AA+/Stable/IND A1+	Long-term rating assigned; short-term rating affirmed
Proposed working capital limits**	-	-	-	INR4,700 (reduced from INR5,000)	Provisional IND AA+/Stable/ Provisional IND A1+	Affirmed
Commercial paper (CP)	-	-	7-365 days	INR8,000	IND A1+	Assigned

** The ratings are provisional and shall be confirmed upon the sanction and execution of the loan documents for the above facilities by DRL to the satisfaction of Ind-Ra.

Analytical Approach: The agency has taken a consolidated view of DRL and its subsidiaries while arriving at the ratings. The company has 52 subsidiaries and step-down subsidiaries in India and overseas, which are engaged in the manufacturing and selling of pharmaceutical formulations.

KEY RATING DRIVERS

Strong Business Profile: DRL has a strong product portfolio and presence across geographies – the US (45% of its consolidated FY19 revenue), India (19%), Russia (10%) and rest of the world (26%). While the company has witnessed increased contribution from non-US geographies; the revenue contribution remains skewed towards the US.

It has a pipeline of 99 abbreviated new drug applications (ANDAs) pending approvals (including 53 Para IV applications, of which around 32 have 'first to file' status) and two pending 505b2 NDAs. DRL proposes to launch 30 new product products in FY20 in the US market (22, including the relaunches of four products that had been discontinued previously, launched in 9MFY20), including limited-competition products. Its products such as gCopaxone and gRevlimid have significant product value. However, the company has faced 8-10 months delay in the launch of its two key limited competition products – gNuvaring and gCopaxone – due to pending complete response letters. DRL undertook an impairment charge of INR11.1 billion on gNuvaring due to adverse market conditions.

DRL's active pharmaceutical ingredient (API) business further provides backward integration.

Improved Credit Profile: At 9MFY20, DRL's net adjusted leverage (net debt/EBITDA) turned negative at 0.1x after improving to 0.4x in FY19 (FY18: 1.3x). This was primarily on lower gross debt (9MFY20: INR16.3 billion, FY19: INR38.4 billion, FY18: INR50.7 billion) along with improved profitability. Interest coverage (EBITDA/interest) remained strong at 42.5x in 9MFY20 (FY19: 35.8x, FY18: 29.8x). Ind-Ra believes the company's net adjusted leverage will remain strong at below 1.0x over FY20-FY22 in view of no major debt funded capex and improving profitability.

US Business Likely to Revamp: DRL's US business's revenue fell at a CAGR of 7.4% over FY16-FY19 due to customer consolidation, pricing pressure in key products and delays in new launches due to warning letters at its various manufacturing facilities. However, Ind-Ra believes the regulatory clearance received for two of its three affected facilities, the increasing contribution of new product launches (including limited-competition gSuboxone), and the industry's contained price erosion compared to historical trends will help DRL's US business to revamp gradually. This was also evident from a 3.5% yoy revenue increase in the company's US Global Generics business in 9MFY20.

Since US is a major contributor to DRL's overall revenues, Ind-Ra believes its performance in this market will remain critical for the ratings as this business remains exposed to higher regulatory risk.

India and Emerging Markets to Drive Revenue Growth: Over FY16-FY19, DRL's revenue from branded generic markets such as India and emerging markets grew at a CAGR of around 7% each against DRL's total revenue fall of 0.3%. The growth in the branded generic markets was primarily led by new product launches, improved realisations as well as the higher volumes of existing products. Ind-Ra believes DRL will continue to expand its presence in these markets through brand building, focus on bio-similars and oncology portfolio. The company is also planning to widen its reach in the Chinese markets.

Overall revenue increased 14.4% yoy to INR130.7 billion in 9MFY20 (FY19: INR154 billion (8.2% yoy), FY18: 0.6% yoy), thanks to growth recorded across geographies, one-time licencing fee related to proprietary products business; however, this was partially offset by supply disruptions in the PSAI segment, especially in 1QFY20. Excluding a one-time licencing fee, revenue grew 7.9% yoy. EBITDA margin (excluding one-off impairment charge of INR16.8 billion) also improved to 24.5% in 9MFY20 (9MFY19: 20.7%, FY19: 20.6%, FY18: 16.5%), supported by lower research and development expense and cost rationalisation measures undertaken by the company.

Liquidity Indicator - Superior: DRL had healthy cash and liquid investments of INR19.6 billion at 9MFY20 (FYE19: INR24.6 billion, FYE18: INR20.9 billion). DRL also had unutilised credit lines of INR35.1 billion at end-December 2019 at the Indian entity and unused credit lines of INR21.4 billion at subsidiaries' level at end-September 2019, which augments its liquidity position.

According to Ind-Ra's calculation, the company's free cash flow increased to INR15.5 billion in FY19 (FY18: INR1.9 billion) primarily on improving profitability and lower capex (FY19: INR8.4 billion, FY18: INR11.0 billion). The management plans to incur capex of INR6.0 billion-INR7.0 billion over FY20-FY21, which is likely to be funded through internal accruals. The company has a debt repayment obligation of INR4.3 billion in FY20 and INR6.7 billion in FY21. The company has not availed moratorium for its term debt repayment obligations. Ind-Ra expects the company's free cash flow to remain positive over FY20-FY22 on improving profitability and limited capex; DRL is likely to maintain high cash balances in line with the historical levels over the same period.

Regulatory Concerns Partly Resolved; Risks Persists: DRL received regulatory clearance for two of its three facilities under warning letters over February-May 2019. These include the oncology injectable formulation facility in Duvvada and the API manufacturing facility in Miryalagu. However, its API facility in Srikakulam continues to be non-compliant. These three facilities received warning letters from United States Food & Drug Administration (USFDA) in November 2015, which limited new ANDA filings from the facilities. Consequently, the majority of pending ANDAs were transferred to third-party sites, and new ANDAs are being filed by other USFDA approved facilities and third-party sites. This resulted in muted revenue growth and lower margins in DRL's US generics business. However, in January 2020, the company received further observations on its Srikakulam facility. Considering that one of the company's key new product gCopaxone is filed from the Srikakulam facility, its timely clearance remains a key rating monitorable.

In 2019, the USFDA increased the scrutiny of facilities of Indian pharmaceutical companies, which exposes DRL to regulatory risks.

Moreover, at FYE19, around 20% of DRL's products were under price control in India. However, DRL's ability to increase its chronic focus through in-house launches and the ramping-up of its in-licensed products, an improvement in field force productivity as well as the scaling-up of its niche portfolio of monoclonal anti-bodies, leading to increasing market share will be critical in improving its domestic competitive position.

Acquisition of Part of Wockhardt's Indian business: In February 2020, DRL entered into a definitive agreement with Wockhardt Limited (IND BB+/RWE) to acquire select divisions of its branded generics business in India and a few others in Nepal, Sri Lanka, Bhutan and Maldives for a consideration of INR18.5 billion. DRL will acquire a portfolio of 62 brands in multiple therapy areas such as respiratory, neurology, vitamins, minerals and supplements, dermatology, gastroenterology, pain and vaccines, which will be transferred to it along with the related sales and marketing teams. The manufacturing plant in Baddi, Himachal Pradesh, with all the plant employees will be transferred to DRL too. According to DRL's management, the acquired portfolio consists of leading brands such as Practin, Zedex, Bro-zedex, Tryptomer and Biovac, which will help the company strengthen its domestic market position. The acquisition is in line with DRL's strategy to expand its presence in the Indian markets and also to de-risk itself against the regulatory pressure in the US markets. The transaction is likely to close by end-1QFY21, and the revenue and EBITDA will start consolidating from 2QFY21. The transaction is likely to be largely funded through internal accruals except for some short-term funding to handle timing mismatch.

The agency has factored in debt-funded, EBITDA-neutral acquisitions of around INR40 billion over FY21-FY22 (in line with the acquisitions made over FY16-FY17). While the company has adequate headroom for this current transaction, Ind-Ra will assess any further mergers and acquisitions on a case-to-case basis and review the ratings accordingly. Any significant delay in the consolidation or integration of the acquired business will remain a key rating monitorable.

Impact of COVID-19: The pharmaceuticals sector falls under essential services, and hence, continues to be operational despite the ongoing nation-wide lockdown. Demand for DRL's products remains strong in India as well as the US, and the company's plants are operating at around 70%-80% of their capacity. On the supply side, DRL's exposure to China in terms of raw material requirement is less than 10%. While there were some disruptions in the supply from China during February–March 2020, the same has now been resumed. However, the company did face certain challenges with respect to logistics, particularly in the initial weeks of lockdown. Furthermore, the lockdown has led to a decrease in the number of patients visiting doctors, which may lead to lower volumes. Consequently, Ind-Ra believes that DRL's revenue and EBITDA margins could be lower than the previous base case assessment. However, the same is likely to be more than offset by the integration of the Wockhardt business in FY21. Moreover, the agency believes that the company's credit metrics are strong enough to withstand any temporary impact from the COVID-19 outbreak.

RATING SENSITIVITIES

Positive: Improved revenue diversification and EBITDA across geographies as well as branded and generic markets, and the company's ability to timely launch meaningful products along with maintaining the credit metrics, all on a sustained basis, will be positive for the ratings.

Negative: Future developments that may, individually or collectively, lead to negative rating action include:

- deterioration in the business profile due to the company's inability to launch meaningful products and/or greater-than-expected price pressure in its relevant markets
- an increase in the net debt levels due to large, debt-funded acquisitions and/or capex, leading to the net adjusted leverage exceeding 1.5x on a sustained basis

COMPANY PROFILE

DRL was established in 1984 and is promoted by Dr. K. Anji Reddy and his associates. The company is a vertically-integrated pharmaceutical formulation manufacturer based out of Hyderabad. It has a diversified manufacturing footprint spread across India, the US, the UK, China and Mexico. The facilities have regulatory approvals from major international drug regulators. The company is listed on BSE Ltd, National Stock Exchange Limited and New York Stock Exchange. Segment wise, DRL derives 75% of its revenue from global generics, 17% from PSAI and 6% from proprietary products.

FINANCIAL SUMMARY (Consolidated)

Particulars	**FY19**	**FY18**
Revenue (INR billion)	154.48	142.81
EBITDA (INR billion)	31.78	23.51
EBITDA margin (%)	20.6	16.5
Gross interest coverage (x)	35.8	29.8
Net financial leverage (x)	0.4	1.3
Total debt (INR billion)	38.38	50.71
Free cash and liquid Investments (INR billion)	24.63	20.88
Source: DRL, Ind-Ra Note: Financial measures such as EBITDA and cash flow measures has been adjusted in line with the agency's rating criteria for Corporates		

RATING HISTORY

Instrument Type	**Current Rating/Outlook**			**Historical Rating/Outlook**		
	Rating Type	**Rated Limits (million)**	**Rating**	**11 February 2020**	**20 December 2018**	**18 September 2017**
Issuer rating	Long-term	-	IND AA+/Stable	IND AA+/Stable	IND AA+/Stable	IND AA+/Stable
Fund-based limits	Long-term	INR100	IND AA+/Stable/IND A1+	IND AA+/Stable	IND AA+/Stable	Provisional IND AA+/Stable

Non-fund-based limits	Short-term	INR1200	IND AA+/Stable/IND A1+	IND A1+	IND A1+	Provisional IND A1+
Proposed working capital limits	Long-term; Short-term	INR4,700	Provisional IND AA+/Stable/ Provisional IND A1+	Provisional IND AA+/Stable/ Provisional IND A1+	-	-
CP	Short-term	INR 8,000	IND A1+	-	-	-

COMPLEXITY LEVEL OF INSTRUMENTS

For details on the complexity levels of the instruments, please visit https://www.indiaratings.co.in/complexity-indicators.

SOLICITATION DISCLOSURES

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Ind-Ra currently maintains coverage of corporate issuers, financial institutions (including banks and insurance companies), finance and leasing companies, managed funds, urban local bodies and project finance companies.

Headquartered in Mumbai, Ind-Ra has seven branch offices located in Ahmedabad, Bengaluru, Chennai, Delhi, Hyderabad, Kolkata and Pune. Ind-Ra is recognised by the Securities and Exchange Board of India, the Reserve Bank of India and National Housing Bank.

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For more information, visit www.indiaratings.co.in.

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Applicable Criteria

Corporate Rating Methodology

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