

STRATEGY

## A recovery is underway at Dr. Reddy's: results from US-business tweaks and CEO's hawk eye on returns

(From left) Erez Israeli, CEO, Dr. Reddy's and G V Prasad, co-chairman and managing director, Dr. Reddy's; image credit: courtesy

### Synopsis

When Erez Israeli took the helm at the pharma major, he adopted a strategy to expand into more geographies, reduce focus on specialty drugs, and double down on generics. Cutting risk and costs were also high on the to-do list. A year down the line, the efforts are beginning to show results.

Around 2014-15, Dr Reddy's Laboratories was losing its grip on operations and had received warning letters from the US drug regulator for three of its manufacturing sites. Growth and profitability also reduced subsequently.

Not many promoters in India would be keen on taking a back seat in such situations, but Satish Reddy and GV **Prasad** believed that a professional approach could revive the company.

Prasad decided to change team structures and bring in fresh leaders for operations, quality, and certain other functions. He was also looking for a new chief executive officer (CEO) but was not able to find a suitable person. The search finally ended in 2018, when the company zeroed in on Erez **Israeli**, who first joined as a chief operating officer (COO) and was elevated to CEO after a year. The overhaul seems to be paying off.



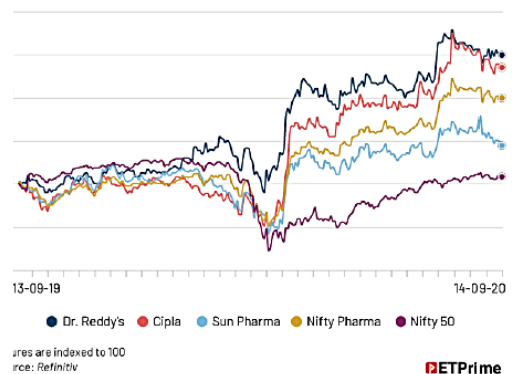
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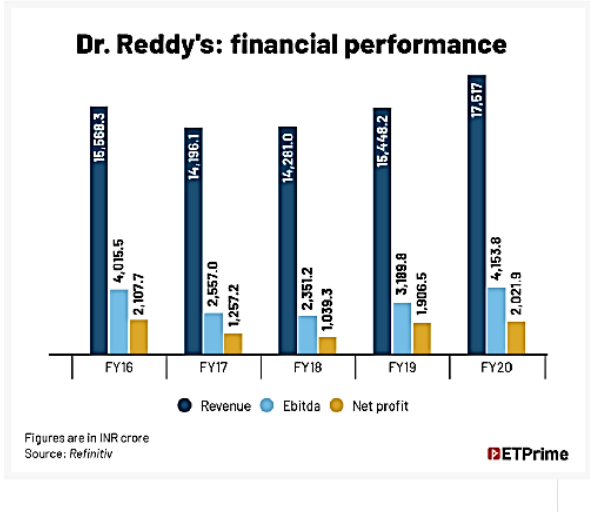
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Sep 17, 2020, 08:27 AM IST

### The Dr. Reddy's stock beats peers and benchmark indices



In fiscal 2019-20, the company recorded its highest ever revenue of INR17,460 crore and Ebitda (earnings before interest, tax, depreciation, and amortisation) of INR4,643 crore. Its stock price has soared more than 80% in the last one year and touched new highs, outperforming its peers as well as benchmark indices. So, what put Dr. Reddy's on the path to recovery?



The strong financial performance of FY20 cannot be fully attributed to the new CEO, as several efforts on building product pipeline and cost rationalisation were taken before he joined. Nevertheless, Israeli's focus on bringing in accountability and the changes he made to the business strategy did have a meaningful impact.

Prasad says expectations from Israeli were clear — correct cost structures; improve processes; and leverage the company's assets and people to drive growth.

Israeli got to work immediately. He tells ET Prime that his main priorities were to resolve regulatory issues at manufacturing sites; fix cost structures and become competitive; and amend the growth strategy with a focus on key markets.

Last month, the US Food and Drug Administration (USFDA) closed the warning letters issued in 2015 on the three sites of Dr. Reddy's, removing the regulatory overhang and paving the way for more product launches.

The generics business in the US has become very competitive and hence keeping costs in check has become critical. Dr. Reddy's has taken several measures to reduce R&D costs, selling and general expenses, and staff costs. Some of these efforts have started reflecting in earnings.

However, R&D productivity in the US is still low and overheads are high. These need to be corrected, says a pharma consultant.

	FY16	FY17	FY18	FY19	FY20
R&D spend (% of sales)	11.5	13.9	12.9	10.1	8.8
SG&A* expenses (% of sales)	29.5	32.9	33	31.8	28.7
Employee cost (% of sales)	16.8	18.5	19.1	18.8	16.6
Capital expenditure (INR crore)	1190	1120	920	700	480

\*SG&A: Selling, general and administrative  
Source: Company reports; Refinitiv

A few years ago, the company had put a lot of capital resources in the US, developing complex generics, specialty drugs and biologics programmes, but the risk was high and so the company altered its strategy. "The biggest change on the strategy side was diversification of opportunities, less focus on the US, less specialty and more generics, less risk, and control on costs," Israeli says.

ET Prime, in its story last year when Israeli became the CEO, had highlighted the areas of focus for the company.

One year on, where does the company stand?

### Diversifying the product and geographic mix

Dr. Reddy's is committed towards as a diversified business with focus on broad-based and profitable growth with limited dependence on any single geography or a few products.

The US has been the biggest market for Dr. Reddy's and over the years, the company has invested significantly in developing products dedicated to the US market. But now it is looking to leverage these products in other countries as well and develop products for global markets.

"We can use the same infrastructure, the same R&D centres but serve more markets with our products. So, we are going to Europe, emerging markets, China, and Russia. We have decided to focus on India and have more growth, as the level of unmet needs and the value that we can bring is higher," Israeli says.

This is likely to bring cost efficiencies and increase scale across geographies, while de-risking from the US market.

"We select a product that can be marketed in many countries. So, we get the benefit that R&D dollars are not just targeted at the US, but in many major markets. This approach will make us more productive," says Prasad, adding that the glory days of the generic industry when a company could make a lot of money by just being in the business are gone.

Dr. Reddy's has steadily reduced its dependence on the US market over the last five years. In FY16, the US market accounted for 49% of the total revenue, which came down to 37% in FY20. The share of business from India and emerging markets has increased.

However, when compared to its peers like Sun Pharma, Cipla, and Lupin, the size of Dr. Reddy's India business is still small, at 17% of the revenue. Earlier this year, Dr. Reddy's acquired a portfolio of 62 brands from Workhardt for INR1,483 crore to enhance its offerings in India.

Israeli says the company is increasing capital allocation for the India market and may continue to look at more inorganic opportunities to expand its product portfolio in the domestic market.

For over two decades, Dr. Reddy's has been in China, a key market accounting for sales of about USD150 million. Its understanding of the Chinese market, easing of regulations there, and rising demand, can help the company achieve further growth.

On the product side, the company is focusing on injectables and it has built strong capabilities in this segment. "Currently, injectables is probably less than 20%, but in the future it's going to be big.... We have manufacturing sites and a big portion of our R&D budget

is going for injectables. We will be launching more injectables in the future across the markets we operate in," Israeli says.

However, an analyst with a domestic brokerage firm says, "Although the company is focusing on diversifying, the major growth driver still remains the US market. Other pieces like India, Russia, China, APIs are still work in progress. But directionally, the company is on the right track."

### The strategy for the US

Dr. Reddy's used to earlier focus on making a handful of big launches in the US, but those opportunities have dwindled. Therefore, Israeli plans to launch a wider range of products and strengthen the base business. "Earlier, we used to launch fewer than 10 products in the US, but last year we launched 25, and this year we are on track for another 25," he says.

The company aims to launch products that have limited competition, better productivity, which means the company's R&D spend on them will be low and have a lower cost structure. "This way, I see growth coming from both top line and bottom line by being better on productivity," Israeli says.

So far in FY21, the company has launched 12 products in the US.

Prasad adds that multiple players are filing for the same product on the same date, so opportunities to get sole exclusivity have become rare. "There is a basic business that you have to strengthen by being competitive, but that won't get you much money. It will help you stay in the game, but money will come from products that you develop, which are somewhat difficult to make and there is less competition."

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— Erez Israeli, CEO, Dr Reddy's

Dr. Reddy's recently launched a generic version of Ciprodex Otic Suspension in the US, the first generic

player to launch it. With a market size of USD453 million, this is likely to be a meaningful contributor to the US business. A couple of more such launches are also expected this year. Moreover, traction in generic Suboxone sales in the US is also expected in the current year, analysts say.

In FY20, the US business recorded sales of INR6,466 crore, up 8% from the previous year.

Prasad says that strength in portfolio, market share, and cost structure are the factors for success in the US.

As of June 30, the company had 101 generic drug filings pending for approval with the USFDA. Out of the pending abbreviated new drug approvals (ANDAs), 54 are Para IVs, and 28 potentially have 'First to File' status, Dr. Reddy's said in its latest earnings press release.

According to a recent note from Citi Research, non-oral solids now make up a third of the company's US revenues and around two-thirds of its pending ANDAs fall in this category, auguring well for sustainability.

### The way ahead

Prasad points out the top three priorities for the company:

- **Leadership:** "The geographies we consider important are where we want to be the leaders, and India is one of them. We have few select businesses and geographies where we will drive for leadership."
- **Productivity:** "We will have an ongoing process of improving our structural cost, which will help us provide affordable medicines around the world as well as keep us competitive."
- **Innovation:** "This will be patient focused. Innovation will be in products, services, and digitalisation. We are going to drive innovation and efficiency together to attain leadership."

"We will work on these three areas simultaneously....It will not be like having growth at the cost of productivity or productivity at the cost of growth, or productivity at the cost of innovation," Prasad adds.

Israeli says financially he is committed to two parameters — RoCE (return on capital employed) and Ebitda. "Every activity has to yield at least 25% Ebitda and 25% RoCE, which means having the business model to generate this. It doesn't mean that all our businesses are doing that, but we are getting there. We need to give compelling business value to our customers and that too in a productive manner."

Dr. Reddy's strong performance highlights the company's improved resilience after its efforts to reduce dependence on US generics, broaden its product portfolio, and drive productivity gains. Citi Research note states, there is more room for margin and RoCE expansion over the next few years, which should support multiples.

"There is absolutely a different way now that we are looking at execution. I am expecting managers across functions to make a commitment and deliver on that, so the level of accountability is better. And once we are more accountable and more committed to ourselves and our customers, the performance improves. It starts from accountability and being professional," Israeli sums it up.

*(Research support by Rochelle Britto; graphics by Mohammad Arshad)*