Dr. Reddy's Laboratories Limited

Annual Report 1998-99

Dr. Reddy's
LABORATORIES

ANNUAL REPORT 1998-99

Hyderabad, 30 August 1999:

"A flexible mindset, and adaptive business models are critical to success in the rapidly changing globalised environment...At Dr. Reddy's we have a vision for our people to transform themselves from change followers to change leaders." This statement of Chairman Dr Anji Reddy sets the tone of the Annual Report of Dr. Reddy's Laboratories for 1998-99.

The FY99 Annual Report records the company's efforts over the years to match change with change on its way to becoming the global corporation that it is today. Signs of its increasing globalisation are visible in the growing proportion of its revenues deriving from overseas operations, joint ventures in Russia and Brazil, hiring of local people in countries where it has significant operations and in brand building activities. A leading brand on home ground, Omez (omeprazole), belonging to the gastrointestinal therapeutic segment, fetched the company close to Rs. 540 million in sales revenues in India and the international market in FY99. The manufacturing facilities of Dr. Reddy's conform to international standards and have undergone inspection by international regulatory agencies.

Dr. Reddy's Laboratories strives to make its Annual Report more than a statement of accounts or a calendar of events for the fiscal. It is a document epitomising the conscious and on-going effort by the company to achieve transparency in management and dissemination of information, eliminate surprises to shareholders, and capture intrinsic values.

Over the last three years, Dr. Reddy's has made a shift in its accounting practices. Its values are now weighted more towards the company's implicit strengths than the purely physical ones. In its pursuit to capture this hidden worth, Dr. Reddy's has incorporated tools for intangible accounts in the Annual Report. These include Calculated Intangible Value (CIV) - an attempt to put a rupee value on the Intellectual Capital in the Company; Economic Value Added (EVA); Market Value Added (MVA); and Total Shareholders' Return (TSR). The company has done an evaluation of the "Dr Reddy's" brand. It has also attempted to capture the value of its human resources.

The Annual Report carries a section on Corporate Governance, which is a statement of commitment from the management to maintain the highest standards of corporate ethics and management control over the business. Dr. Reddy's has complied with most of the recommendations enlisted under the code on corporate governance published by the Confederation of Indian Industry (CII).

Dr. Reddy's recognizes the importance of compatibility of accounting standards in its efforts to access global markets. The company has adhered to International Reporting Standards by including voluntary disclosures as per the US GAAP and in the SEC stipulated Form 10K.

Going beyond statutory requirements, the company started the practice of including a social responsibility statement from 1997 as a measure of its commitment to the community. In this section, Dr. Reddy's provides shareholders with a report on the progress of the social programme that it pursues under the aegis of Dr. Reddy's Foundation for Human & Social Development. Dr. Reddy's has taken a slightly different route in this area. It involves all stakeholders as partners in any community initiatives. This approach serves a two-fold purpose: ensures the success of the programme by instilling a sense of ownership, and makes creative resource management easier.

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Global concern...

A Hyderabad, India, based pharmaceutical R&D outfit discovers a new medicine for Diabetes. A Danish based multinational buys the license to the discovery, a process mediated by consultants and lawyers in New York.

The Danish Company carries out human trials of the new medicine in the United Kingdom. If these trials are successful, the data will be submitted to regulatory authorities all over the world, including the largest market for pharmaceuticals, the United States. If the medicine is approved, it will be sold in the US market where Americans with Diabetes will be able to purchase it from their pharmacy. Unknown to them, a portion of the price they pay to buy the medicine will flow back to the Indian Company that discovered the medicine, several continents and time zones away.

"A flexible mindset, and adaptive business models are critical to success in the rapidly changing globalised environment....

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Dr. Anji Reddy
Chairman

This then, is the essence of globalisation. And for those of you who follow news about Dr. Reddy's closely, you will recognize that the first part of this story is already fact. Globalisation is here and now. Indeed it can be said that the pharmaceutical industry is already highly globalised. This is natural for an industry which sells its products in diverse markets with very little local customization. Regional regulatory barriers which impede a global approach to drug development and marketing, are quickly being simplified and harmonized to make the process simpler. Multinational pharmaceutical companies which always had vast international reach are becoming ever more omnipresent. The WTO will drive further dismantling of barriers to free trade and capital flows, thus ensuring a further increase in the pace of globalisation.

What are the broad trends impacting this globalised pharmaceutical industry? One major trend that has been seen over the last decade is the move towards greater consolidation through mergers and acquisitions. Critical mass is seen as guaranteeing long-term success. Such critical mass is necessary because many of the large pharma companies have unsustainably thin new product pipelines at a time when the huge cost of drug development is imposing an ever escalating penalty on failure. Size also supports the worldwide drug launches and marketing efforts necessary to efficiently derive the economic benefits of the innovation. This is especially important at a time when regulatory authorities are unwilling to tolerate the predatory pricing policies of multinational pharma companies.

Globalisation also means the end of the double-standards. Companies all over the world will have to operate to similar standards, whether it be environmental standards, manufacturing quality standards or clinical trial standards. This will increase the trend among companies to greater outsourcing of products and services, from those regions of the world that have the greatest competitive advantage in a particular area.

In this environment, it is appropriate to reflect upon the challenges Indian companies like Dr. Reddy's will face. What place will we take in the international pharmaceutical order in a globalised world?

Dr. Reddy's Laboratories is already on its way to emerging as a global corporation. A growing proportion of our revenues derive from our overseas operations. We have Joint Ventures in Russia, Brazil and China. In the countries where we have significant operations, we hire local personnel. Our brands are sold in a number of different countries where they enjoy high visibility with local physicians. Our manufacturing facilities conform to international standards and have undergone inspection by international agencies. These efforts constitute a modest beginning on the route to globalisation. There are a number of other challenges and opportunities that we will have to address as we progress along this journey.

It has been said that Indian pharma companies, due to their smaller size, will find it difficult to survive in the global economy. The pursuit of critical mass through consolidation, as we are seeing among the large pharma companies, supports this perception. A significant counter-trend, however, discounts this possibility. The pharma industry is driven by innovation and the centre of gravity of innovation has shifted to the biotech companies. This trend is partly due to the rapid pace of innovation from the new science of Genomics. Culturally, large organisations are not nimble footed enough to match the cutting-edge innovative skills that thrive in the entrepreneurial environment of the small biotech companies. Indeed, it is estimated that greater than 50% of the development pipeline of new products in large pharmaceutical companies will consist of molecules that were originally discovered by small biotech companies. There are also niche positions occupied by several small to medium sized pharma companies that are focussed either on a specific therapeutic segment, such as women's health, or a specific platform technology, such as Drug Delivery Systems. Such companies have shown great resilience in the face of the current shakedown in the international pharmaceutical industry. These observations indicate that there is room in the globalised pharmaceutical industry for players of different sizes and different approaches. Indian companies need not fear globalisation, as long as they can transform themselves into innovators.

A key ingredient for innovation is high-quality people. Indian pharma companies enjoy tremendous advantages in terms of the human resources they can deploy. The transformation of a trade deficit in pharmaceuticals in the 70s to a significant net surplus in the 90s has been possible due to our scientific and technical skills in chemistry. The track record in Drug Discovery, however, is relatively modest due to the lack of product patents. This is destined to change with the new product patent regime. A significant trend is already apparent, with Indians filing 50 patents in the area of pharmaceuticals and biotech in the US in the years 1992-1996, a five-fold increase over 1987-91. Moreover, this trend continues to show signs of growth over the long-term.

A flexible mindset, and adaptive business models are critical to success in the rapidly changing globalised environment. Fortunately, Indians have shown tremendous capacity to adapt to the environment. This partly explains the success of Indians who migrate overseas. This trait is also a useful one to harness in responding to rapid change in the globalised environment. At Dr. Reddy's, we have a vision for our people to transform themselves from change-followers to change-leaders. You will find more on the subject of change in the pages that follow.

In the globalised world, India will constitute an extremely important market for products and services. Indian companies enjoy the advantage of having this large and growing market for their products at their very doorstep. Given the current extremely low levels of consumption of pharmaceuticals in India ($3 per capita compared to $200 per capita in the US), there is tremendous upside potential. However, this is not a marketplace to be taken for granted. The Indian consumer is an extremely discerning customer. As an Indian Company it is our responsibility to understand the Indian customer and serve his or her needs in the best manner possible. This understanding can be built in a variety of different ways. For example, we need to increase the volume of drug oriented clinical research in this country, with the aim of better understanding what makes us different as Indians. We also need research on the genomic identity of Indians. This can throw light on differences in disease susceptibility and drug response in the Indian population. Eventually, this information must be shared with physicians and patients so that healthcare can become more appropriate to our needs. Building such bridges of understanding will not only help us innovate better products, but will also give us a strong and credible presence in the globalised Indian marketplace.

The globalised economy of the future will be a knowledge economy. The creation of new knowledge, as described above is one part of the puzzle. What remains is to also learn to use the new technologies of communication, such as the Internet, to make this knowledge available inexpensively to the largest number of people. Given our strengths in software and systems and the Indian government's increasingly enlightened approach towards building an information network in the country, I see new and creative initiatives being launched within the country that use the Internet to disseminate healthcare information. Since the Internet recognizes no borders, India could conceivably be the hub for the global information economy. As a pharma Company, we need to take advantage of this emerging trend.

The globalised world economy will also call for skills in relationship management and networking. No company, however large, can afford to remain an unconnected island. Our experience with the first two molecules we licensed to Novo Nordisk has taught us many lessons. In a sense, it was a coming of age that has prepared us for the future. We will continue to seek and build these kinds of relationships. Just as we seek partners from other countries for our technology, we must also take advantage of the large scientific base within the country. We are already doing this in a small way and I see this kind of activity growing in the future.

Unbridled globalisation will bring with it a new set of problems. In the new hyper-competitive environment, there will be significant losers. The impoverished, the illiterate and the unskilled will have to face the brunt of the dislocations brought about by globalisation. While it can be expected of governments to play a responsible moderating function, corporations too must share some responsibility and avoid the temptation to act like soulless entities. In India, for example, Dr. Reddy's has always had the reputation of making high-quality and life-saving medicines at affordable prices. We must not look away from this responsibility to the Indian people in the globalised environment. Even as we grow to be a global concern, we must not leave behind our local concerns.

Dr. Anji Reddy
Chairman

"In the arena that we compete, tough challenges lie ahead of us. But we are confident, as we have done in the past, to take them head on and achieve progress that will make Dr. Reddy's the leading Indian healthcare Company."

Satish Reddy
Managing Director

"The old order changeth yielding place to the new"- how true the words of the great 19th century scholar poet, Lord Alfred Tennyson ring, even as we're on the threshold of the next millennium. The prophetic words are also relevant in the context of the mechanics of change that has been driving our Company, Dr. Reddy's, through various stages of evolution. Remember our beginnings as a Bulk Actives Company and the conscious transformation to a fully integrated pharmaceutical major with Drug Discovery, Finished Dosages, Bulk Pharmaceutical Ingredients and Intermediates in our ever-expanding bandwidth! It certainly has been a change for the better.

Our standing today in the pharmaceutical industry could be accomplished through team effort and a change in mind set, from the very bottom right up to the top. It also represents a successful shift from an entrepreneurial way of working to a professionally managed one, without losing sight of the entrepreneurial spirit resident in each and every individual. Our experience has shown that successful strategies evolve out of the pulse of the market place, not the antiseptic environment of an ivory tower.

Onwards, the process gets only tougher. In the arena that we compete, tough challenges lie ahead of us. But we are confident, as we have done in the past, to take them head on and achieve progress that will make Dr. Reddy's the leading Indian healthcare Company. We are confident because of our resources and the capabilities we have built and continue to build at DRL.

During the year 1998-99, our Company made significant progress in its various business segments. The Finished Dosages segment recorded a turnover of Rs.2484.77 million, an increase of 20% over the previous year, and contributed to 58% of the total turnover. This, in spite of declining sales in Russia due to an economic crisis at a very early stage of the financial year. Bulk Actives recorded a sales of Rs.1632.43 million and the balance came from the Emerging Businesses of Diagnostics and Critical Care. Earnings from basic research sponsored by DRL were US$ 2 million.

The Indian finished dosages market continues its phase of consolidation. Our strategy of brand acquisitions continued with acquisition of six more brands during the year. In the next phase of consolidation, we expect a strong M&A activity within the industry and it is Dr. Reddy's intent to participate in this activity as part of its strategy for growth. The pharmaceutical market is growing at the rate of 14% and it is our endeavour to out-pace the market's growth rate year after year.

Our foray into the international markets for finished dosages commenced with Russia early this decade. Having made significant inroads into this market early in its operations, DRL has now shifted its focus onto the potentially large markets of Brazil and China, making its entry through the Joint Ventures route.

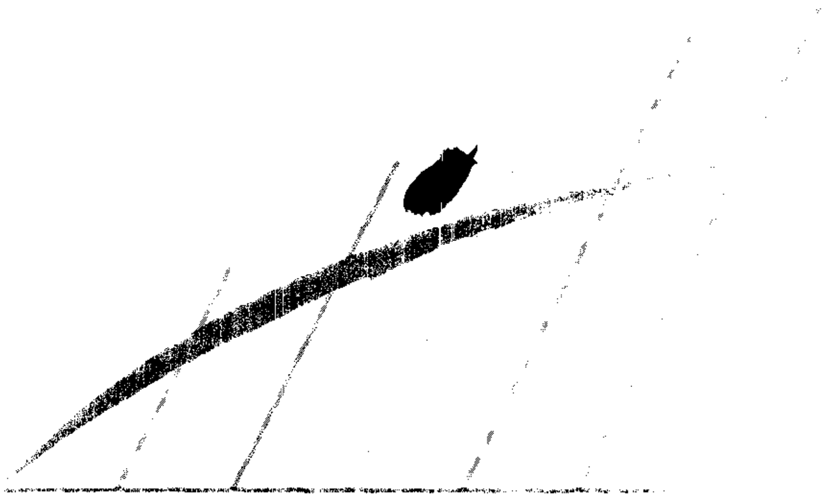
The Bulk Actives business continues to witness volatility in the markets in India as well as overseas. Although the volumes show a significant increase, the pricing on products are subject to pressure frequently. DRL intends to move up the value chain by reconfiguring its product and customer portfolio to move onto the more value-added segments of the market.

Basic research activities sponsored by DRL at the Dr. Reddy's Research Foundation witnessed more breakthroughs with the licensing of a second anti-diabetic molecule, DRF2725 to Novo Nordisk during the year. With leads in other therapeutic categories, DRL has emerged as the most prolific research based Company from India.

The outlook remains bright for Dr. Reddy's and with continued support from the shareholders, employees, banks and financial institutions, the medical community and patients, we are sure to exceed your expectations from the Company.

Satish Reddy
Managing Director

Finished Dosages



Marketing/ India

Adapt to become adept. This is the story of change at Dr. Reddy's Laboratories.

Dr. Reddy's overhauled its product portfolio to consolidate its strengths in the core area. The basket expanded to strengthen the gains made in core therapeutic segments like Gastrointestinal, Cardiovascular, Infection Control and Pain Control. The Company adopted the brand acquisition route after realizing that mere organic growth would not be enough to stay ahead of competition. The new product development pipeline is now dependent on market potential and customer need only. Line extensions became the strategy to cater to individual customer needs and strengthen the brand by widening the prescriber base.

From pricing as the strategy for penetrating the market in its formative stage, Dr. Reddy's shifted to offering the right price for the product that customers will perceive as 'value for money'. This metamorphosis resulted from the changed industry scenario wherein competition too developed its Bulk Actives R&D and production, which were earlier the unique strengths of DRL. The difference between the two policies is that while pricing strategy is competition driven, right pricing strategy is customer driven.

The Company adopted developments in Information Technology to improve supply chain management to ensure product availability at all times and places in the shortest while possible. This has helped in optimising inventories and will continue to do so. Continuous interaction with trade also helped Dr. Reddy's respond to the needs of the market faster than ever before.

The conventional approach to promotion from the product angle too changed. It changed from product-customer focus to patient need-customer practice focus. The Company charted strategies to create brand identity and strengthen customer relationships. Focus shifted from customer satisfaction to customer delight.

Finished Dosages

Much time and effort have been invested in training and development, process improvement and relationship management as no successful product story is possible without winning the hearts of people.

To capture a major share of the market flooded with branded generics, it is imperative to corner first a share in people's hearts and minds through excellent service. The Company constantly shared the basics of marketing and advertising with sales and marketing teams with the aim on brand building through customer focus. The focus was on creating the right environment and providing the necessary support for its employees, the ambassadors of the Company in the market place.

The outcome of these exercises is that the Company's rank in the pharmaceutical industry improved to 18 on MAT basis as per June 1999 ORG report. DRL has five brands in the top 250 list. The change that took place in the customer's mind share is evident in the Company's position on the prescription front moving from tenth to sixth as per CMARC during November 1998 to February 1999.

Marketing/ International

Smaller markets like Myanmar and Vietnam are the building blocks on which Dr. Reddy's learnt the alphabet of international marketing. Four years of experience in unregulated markets like these and seven in Russia had taught the Company enough to approach the large markets of Brazil and China with confidence but restraint. For these countries, DRL chalked out a clear-cut strategy from the start. It would aim for a regionalised presence in these countries. The 'brand' would be all-important.

Dr. Reddy's capitalized on the lessons that it learnt in Russia. Having become familiar with the pitfalls of international business management, the Company remodelled its overseas strategy. The sales driven approach gave way to one that aimed at a long-term commitment and at creating brand equity. Some of the brands that became leaders in the process are Omez (Omeprazole), Enam (Enalapril Maleate), Ciprolet (Ciprofloxacin), Ketorol (Keterolac) and Stamlo (Amlodipine).

Market orientation replaced institutional sales. The Joint Venture, Reddy Biomed, set up in 1995 for commercial production, through which the Company channeled the business, helped DRL to make the shift. The Company has also identified a few select distributors for making a direct impact. Another priceless education is to give a local face to the Company's operations to make inroads in the market. Dr. Reddy's now curtails exposure in high-risk countries. Sales are against a cash and carry arrangement or against an advance payment as opposed to a credit period of 80-90 days earlier.