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Should we trust the credit ratings?

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Should we trust the credit ratings?



Political events in India and the government's lack of conviction on policy matters have taken their toll on India's image as an attractive investment decision. The change in the country's credit rating outlook by a global credit rating agencies has further dealt a blow. Even as this generated some scare in the industry, many investors and analysts criticized the accuracy of the rating agencies.

Recent deals such as between that of Sanofi-Shantha Biotech, Daiichi Sankyo-Ranbaxy, Abbott-Piramal Healthcare and Hospira-Orchid Chemicals have only highlighted the interest displayed by foreign companies in investing in Indian bioscience firms.

Dr Murali P Muthuswamy, president, Association of Biotechnology Led Enterprises (ABLE), echoes this sentiment as he says that the outlook is all but dim for the bioscience industry, which boasts of a growth rate of around the 20 percent.

Dr Murali is a entrepreneur with more than two decades of experience with many first-of-its-kind products and innovations in many areas of biotechnology. He is creidted with building the entire Indian arm of the $100 million Swiss biotech company, Evolva Biotech, where he is currently the MD and CEO of the India operations. In an email interview to *BioSpectrum*, he talks about whether the scale down and threat of junk rating has affected investor sentiments in the biosciences industry.

Do you think the change in India's credit rating outlook by Standard & Poor's (S&P's) has affected the lifescience industries?
To answer this question let us look at the some of the present figures for pharma and biotech sectors in India.

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1. As per the 10th annual *BioSpectrum*-ABLE Biotech Industry Survey for India this year, "amidst uncertain economic conditions, the biotech industry has performed creditably to cross the $4 billion (Rs 20,000 crore) revenue mark for the first time ever. Last year's 18.5 percent growth has been built on the back of 19, 21, 17, 18, 20 percent growth rates, recorded in the previous five years respectively. It is clear that the industry growth will hover around 20 percent in the near future... Many other industry segments will be happy to have such a steady growth rate. This translates to a compounded annual growth rate (CAGR) of 14.75 percent in the last four years, and a CAGR of 24.18 percent between 2002 and 2012."

2. Other reports have stated that an opportunity worth $70 billion in similar biologics beckons India's biotech industry as we approach the "patent cliff" years of 2015-16.

3. Again, India's pharmaceutical industry has witnessed a robust growth from $11.4 billion in 2010, to $13 billion in 2011, to $17.4 billion in 2012, with a scorching pace of growth of 15 percent. The industry ranks third in terms of volume, globally. Projects worth more than $1.2 billion are currently under implementation at various stages, suggesting massive investments by Indian pharmaceutical companies.

4. Also, it is important to note that healthcare industry has grown from $71.8 billion in 2011 to $77.3 billion in 2012 at a growth of 7.6 percent (11 percent in Rupee terms).

5. The medical devices market has grown from $3 billion in 2011 to $3.2 billion in 2012, growth of eight percent (12.2 percent in Rupee terms)

So, to me the answer is that this sector has largely not been affected. However, India's Pharmaceutical Risk/Reward Rating (RRR) score has dropped from 56 in the second quarter of 2012 to 54.4 during the third quarter of 2012 due to falls in its industry risks and country risk scores. As a result, India's position on the proprietary ranking system is now 10 out of 18 countries, falling a position behind New Zealand.

Do you think credit ratings from such agencies matter?
To understand ratings, it is important to look back in history. For Enron Corp, S&P's, Moody's and Fitch gave no indication of its financial trouble until just days before Enron filed for bankruptcy in 2001. They have been under scrutiny for giving high, "investment-quality" ratings to unworthy mortgage-backed securities.

Then, they were criticized for their favorable pre-crisis ratings of insolvent financial institutions such as Lehman Brothers, as well as risky mortgage-related securities that contributed to the collapse of the US housing market in 2008. In 2009, Moody's issued a report titled 'Investor fears over Greek government liquidity misplaced' within six months of which the country was seeking a bailout. Then, S&P's sovereign debt team miscalculated the US debt by as much as $2 trillion when it downgraded the US credit rating in August 2011.

Recently, Mr Deepak Parekh, chairman, HDFC, suggested that these rating agencies need to be "rated". Not all of them have sufficient exposure to the dynamics and intricacies of this industry due to diversity and complexity. Also, there are several pockets of growth that are still not tapped and it is very unlikely that such agencies may even know about it. Many such ratings are a rear view mirror and may not foretell about future prospects accurately.

However, there are cases where rating agencies have not got their data right. For instance, S&P's rated Spain (BBB+) ahead of India (BBB-) and not many know that the rationale was the prevailing economic scenario of Spain against India's growth story. So, my worry as a citizen and not being an economist is how do I trust these ratings? Also, how much importance should I give them?

Has there been a negative impact on foreign direct investment (FDI) in lifesciences because of the negative credit rating and government flip-flops on FDI?
In August, India's foreign investment approval authority cleared eight pending proposals of foreign drug companies to buy stakes in local companies, which were pending for several months due to lack of clarity on the new FDI norms in the pharmaceuticals sector.

As per the decision from an inter-minsterial group on FDI in pharma, India allows 100 percent FDI in greenfield projects and 49 percent in brownfield projects by the automatic route, while above 49 percent in brownfield requires approval from the FIPB. The group has also decided that a multinational firm buying a stake higher than 49 percent in an Indian pharma company will maintain the same level of investment in research activities and production of essential medicines for five years.

According to some officials, the foreign partner that will gain substantial shareholding in the company will have to assure the government that none of the essential drugs produced by the Indian company will be discontinued after foreign investment. They may also be asked to invest five percent of their turnover in R&D relating to drug that address India specific health problems.

Globally, several countries look at India for providing affordable healthcare and it's even more important to do so for Indian citizens. The government reserves its right to take decisions that are most favorable to its citizens. From this perspective, greenfield projects may be more beneficial to India, given its potential to create new jobs and an ecosystem around it rather than brownfield projects. Even within the proposed brownfield, its important to look at the motive behind the move, especially if it adversely affects country's prospects in the long term by killing competition and increasing prices. Given the significance, the Prime Minister himself is directly involved in this area.

A recent report published in Grant Thornton and cited in HBL indicates that the total PE investments in pharma, healthcare and biotech together increased by a whopping 89 percent; the number of deals jumped from about nine in the first half of 2011 to 17 during the first half of 2012. This was the third sector with such positive change, next only to IT, IT enabled services (227 percent), and banking and financial services (178 percent). Hence, the ratings don't seem to seriously impact the investments.