March 25, 2021

Aarti Drugs Limited: Ratings assigned

Summary of rating action

Instrument*	Current Rated Amount (Rs. crore)	Rating Action
Commercial Paper	90.0	[ICRA]A1+; assigned
Long term: Term loan (USD million)*	USD 15.0 million	[ICRA] AA- (stable); assigned
Total	**90.0** **USD 15.0 million**	

**Instrument details are provided in Annexure-1*

**Though the long-term loans of ADL are denominated in foreign currency, ICRA's ratings for the same are on national rating scale, as distinct from an international rating scale*

Rationale

The assigned rating favourably factors in Aarti Drugs Limited's (ADL's or the entity's) experienced management and established operations spanning over 30 years in active pharmaceutical ingredients (APIs), intermediates, speciality chemicals and formulations. The ratings consider ADL's sizable market share as the largest domestic and global manufacturer for most of its key products. It has an established track record of supplying these molecules and derives significant operational efficiencies from large installed capacities and backward integration of intermediates and related chemicals that protect the company's profitability to an extent. The ratings also take comfort from ADL's diversified and reputed client base, including major pharmaceuticals players with its top five customers driving ~7-10% of its revenues in FY2020 and H1 FY2021.

ADL's operating income (OI) witnessed a healthy CAGR of 9.7% during FY2016-FY2020 and YoY growth of 21.9% in 9M FY2021, led by increasing volumes and realisations (in APIs) across key therapeutic areas. The increase in volumes was supported by ongoing brownfield capacity expansions for APIs and related intermediates, while the increase in realisations was led by changes in product mix and price increases across the API industry. ICRA expects the revenue to grow favourably in the near to medium term led by new product introductions, increasing geographic penetration, and sizable capex over the next three to four years. Further, pharmaceutical companies are increasingly establishing secondary sources of procurement in India to diversify their supply chain, which bodes well for ADL and other domestic API players. The operating margins improved to 15.9% in Q4FY2020 and 21.5% in 9M FY2021 (14.7% in FY2020). The increase in margins in 9M FY2021 was partly contributed by various cost-optimisation measures implemented over the last few years and price hikes across the industry partly, contributed by Covid-19 related supply disruptions.

The capitalisation and coverage indicator ratios remained healthy in FY2020 and improved substantially in H1 FY2021 because of improved profitability. Despite the sizable debt-funded capex in FY2022-FY2023, the leverage profile is expected to remain comfortable supported by consistent profitability and accruals.

The company is undertaking a sizable capex plan of 520.0 crore in FY2022 and FY2023 to enhance its API capacities including maintenance capex. The capex is towards scaling its capacities for APIs, related intermediates and formulations; although with an average gestation period of 18-24 months for the greenfield capex, achieving desired levels of profitability and accruals remains a key sensitivity.

The rating is also constrained by ADL's moderately high working capital intensity because of its large receivables and inventory holding period, as it is bound to maintain a minimum inventory for various raw materials and finished goods to maintain uninterrupted flow of supplies. ADL's profitability is also exposed to regulatory risks, fluctuations in raw material prices, competition from other players and limited upside in pricing flexibility because of large share of mature product portfolio. The risk is mitigated to an extent by its leading market position and backward integration into related intermediates that protect the profitability.

Key rating drivers and their description

Credit strengths

Established bulk drug player with strong presence in therapeutic segments like antibiotic, anti-diarrheal and anti-inflammatory, along with sizeable market share in key molecules - The company caters to 11 therapeutic groups, including antibiotic, antidiarrheal, anti-fungal, anti-diabetic, anti-inflammatory, cardioprotective, vitamins and anti-arthritis, among others. The top three therapeutic segments—viz., antibiotic, antidiarrheal and anti-inflammatory—drove ~62-63% of the company's consolidated revenues in FY2020 and H1 FY2021. ADL has a growing presence in anti-fungal, anti-diabetic and cardioprotective therapies as well. Its top five products, namely Ciprofloxacin, Ofloxacin, Metronidazole, Metformin and Ketoconazole, generated 61.0% and 57.9% of its revenues in FY2020 and H1 FY2021, respectively. ADL has a sizable market share as the largest domestic and global manufacturer for most of its key products.

Diversified client mix; geographical diversification in export customers - ADL's customer base is diversified with its top five customers contributing only ~7-10% of its revenues in FY2020 and H1 FY2021, respectively. Its client profile includes reputed domestic as well as export end-customers and distributors. Any increase in raw material prices are passed to its end-customers with a lag time of two to three months. Export sales comprised 34.5% of ADL's consolidated revenues in FY2020. Although limited, its exports are diversified across 100 countries in Latin America, Asia Pacific, Europe and Africa.

Favourable growth outlook in the near to medium term supported by healthy pipeline of products – ADL's operating income (OI) witnessed a healthy CAGR of 9.7% in FY2016-FY2020 and YoY growth of 21.9% in 9M FY2021, led by increasing volumes and realisations (in APIs) across key therapeutic areas. The increase in volumes was supported by ongoing brownfield capacity expansions for APIs and related intermediates, while increase in realisations was led by changes in product mix and price increases across the API industry. ICRA expects ADL's revenues to grow favourably in the near to medium term, led by new product introductions, increasing geographic penetration, and sizable capex over the next three to four years. Further, pharmaceutical companies are increasingly establishing secondary sources of procurement in India to diversify their supply chain, which bodes well for ADL and other domestic API players. The company has healthy pipeline of recently off-patent products such as Clopidrogel (to be launched in regulated European markets), Vildagliptin, Tenalgliptin and Pregablin.

Healthy financial profile with consistent profitability, healthy capitalisation and coverage indicators - The operating margins in FY2018 and FY2019 were impacted because of supply disruption for intermediates from China on account of closure of several facilities on account of implementation of stricter pollution norms. Subsequently, the company has developed alternate source of raw material and cost-effective manufacturing processes. This led to an improvement in operating margins to 15.9% in Q4 FY2020 from 14.3% in Q3 FY2020. The operating margins improved to 21.5% in 9M FY2021 compared to 14.7% in FY2020 because of operational efficiencies and price hikes across the industry, partly led by Covid-19 related supply disruptions. The global shortages and sustained increase in prices compared to pre-Covid levels led to improved contribution margins for ADL in 9M FY2021. The company continues to benefit from backward integration for its key molecules, anti-dumping duty on Ciprofloxacin and Ofloxacin and operational efficiencies from large established capacities.

The capitalisation ratios remained healthy with a gearing of 0.6 time and 0.5 time in FY2020 and H1 FY2021, respectively. The TD/OPBITDA and interest coverage was recorded at 1.5 times and 7.1 times, respectively, in FY2020. In H1 FY2021, with a significant improvement in profitability, the TD/OPBITDA and interest coverage improved to 0.7 time and 18.4 times, respectively. Despite the sizable debt-funded capex in FY2022-FY2023, the leverage profile is expected to remain comfortable supported by consistently healthy profitability and accruals.

Credit challenges

Significant near-term debt-funded capex; achieving desired level of profitability remains to be seen – ADL is undertaking a sizable capex plan of 520.0 crore in FY2022 and FY2023 to enhance its API capacities including maintenance capex. The capex is towards scaling its capacities for APIs, related intermediates and formulations; although with an average gestation period of 18-24 months for the greenfield capex, achieving desired levels of profitability and accruals remains a key sensitivity. The greenfield capex will be funded by accruals and long-term debt, of which the company has sanctioned part of the long-term debt. The risk is mitigated to an extent by the proven track record of successful implementation of similar projects, leading market position in addressable molecules and flexibility to stagger planned capex, depending on market conditions.

Moderately high working capital intensity - The working capital intensity improved to 25.0% and 27.2% in FY2020 and H1 FY2021, respectively, from 30.5% in FY2019. This improvement was led by efficient receivable collections offset by an increase in inventory amid the pandemic, as on March 31, 2020. The outstanding payables increased temporarily on March 31, 2020 because of the onset of the pandemic and non-payment to suppliers in the last few days of March 2020. The company is bound to maintain a minimum inventory for various raw materials and finished goods to maintain uninterrupted flow of supplies. The working capital intensity is expected to gradually increase to FY2019 levels as operations normalise over FY2022-FY2023.

Profitability remains exposed to regulatory risks, fluctuations in raw material prices and limited upside in pricing flexibility because of sizeable mature molecule portfolio – The company is exposed to regulatory risks like manufacturing facility approvals and local manufacturing requirement by various Government authorities, as part of a regulated industry amid an evolving landscape. It is also exposed to raw material price fluctuations since it imports nearly 55-60% of its total raw materials, although price increases can be passed on to end-customers with a lag period of two to three months. ADL's product portfolio consists relatively high share of mature molecules across therapeutic areas that are subject to limited upside in pricing flexibility. The downside risk is mitigated to an extent by its leading market position and backward integration into related intermediates that protect its profitability.

Liquidity position: Adequate

ADL's liquidity is **adequate**, supported by a significant expected improvement in fund flow from operations of Rs. 290-300 crore in FY2021 from ~Rs. 180 crore in FY2020. The liquidity is further supported by healthy accruals, unutilised working capital limits and unencumbered cash and cash equivalents of Rs. 11.0 crore, as on September 30, 2020. The annual repayment obligation remains moderate at ~Rs. 40.0- Rs. 43.0 crore in FY2021 and FY2022. ADL has a capex commitment of ~Rs. 75.0 crore in FY2021, funded by internal accruals. The capex outlay in FY2022 is estimated at ~Rs. 325.0 crore, which will be financed partly by long-term debt, of which the company has sanctioned Rs. 110.0 crore long-term debt.

Rating sensitivities

Positive factors – The ratings could be upgraded with a sustained improvement in the company's revenue profile leading to increased profit margins and improved financial profile. Specific credit metric which can lead to a rating upgrade include improvement in TD/OPBDITA to below 1.0 times on a sustained basis.

Negative factors – The ratings could be downgraded in case of a significant and sustained deterioration in the company's profitability. Negative pressure on ADL's rating could arise with a weakening in the company's TD/OPBITDA beyond 1.5 times on a sustained basis. The rating could also be downgraded if its liquidity position worsens on account of higher than expected working capital intensity or capex funding requirements.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	Corporate Credit Rating Methodology Rating Methodology for Entities in the Pharmaceutical Industry
Parent/Group Support	Not applicable
Consolidation/Standalone	For arriving at the ratings, ICRA has considered the consolidated financials of ADL. As on December 31, 2020, the company had four subsidiaries, which are all enlisted in Annexure-2.

About the company

Incorporated in 1984, ADL manufactures APIs, intermediates and specialty chemicals. The company was promoted by four chemical engineering graduates from UDCT Mumbai (now Institute of Chemical Technology). ADL derives nearly 30-35% of its revenues from exports in FY2020 and H1FY2021. It has a strong presence in antibiotic, antidiarrheal and anti-inflammatory segments with a growing product portfolio in anti-fungal, anti-diabetic, cardio-protectant, vitamins and anti-arthritis therapeutic groups. ADL's key products include Ciprofloxacin, Metronidazole, Metformin HCL, Ketoconazole and Ofloxacin. It successfully developed around 30 new molecules in the past six years and is continuously developing new value-added molecules through its innovative and cost-effective process. The company has nine manufacturing plants in Tarapur (Maharashtra) and two plants in Sarigam (Gujarat). The manufacturing units have approval from WHO-GMP, EDQM (Europe), accreditation from Japan, ANVISA, ISO 9001: 2000, TGA Australia, COFEPRIS, Canadian Authorities, China, Russia, Taiwan, Ukraine, Vietnam, and Korea.

Pinnacle Life Sciences Private Limited (PLSPL) is a wholly-owned subsidiary of ADL involved in manufacturing formulations for domestic (contract manufacturing) and export markets (own brand). The therapeutic segments it caters to ranges includes CNS, Cardiovascular, Dermatology Ointments, Gastro Intestinal, Oncology, Pain Management and Respiratory. Its facility at Baddi is ISO 9001: 2008 certified and WHO – GMP approved. PLSPL is also approved by various regulatory bodies like FMHACA (Ethiopia), NDA (Uganda), PPP (Kenya), and Ministry of Health (Ivory Coast). Most of its API requirements are met by its parent.

Key financial indicators

ADL Consolidated	FY2019 (Audited)	FY2020 (Audited)	H1 FY2021 (Limited Audit)
Operating Income (Rs. crore)	1560.9	1806.1	1122.8
PAT (Rs. crore)	89.7	141.4	160.7
OPBDIT/OI (%)	13.5%	14.7%	22.3%
PAT/OI (%)	5.7%	7.8%	14.3%
Total Outside Liabilities/Tangible Net Worth (times)	1.7	1.4	1.1
Total Debt/OPBDIT (times)	2.4	1.5	0.7
Interest Coverage (times)	4.8	7.1	18.4

Source: Company; PAT: Profit after Tax; OPBDIT: Operating Profit before Depreciation, Interest, Taxes and Amortisation

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2021)				Chronology of Rating History for the past 3 years		
		Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	Date & Rating in	Date & Rating in FY2020	Date & Rating in FY2019	Date & Rating in FY2018
					Mar 25, 2021	-	-	Nov 15, 2017
1	Commercial Paper	Short term	90.0	-	**[ICRA]A1+**	-	-	-
2	Term loan USD million	Long-term	15.0	-	**[ICRA] AA- (Stable)**	-	-	-
3	Term Loans	Long-term	-	-	-	-	-	[ICRA] A- (stable); ISSUER NOT COOPERATING; withdrawn
4	Cash Credit	Long-term	-	-	-	-	-	ICRA] A- (stable); ISSUER NOT COOPERATING; withdrawn
5	WCDL/PCFC /STL	Short term	-	-	-	-	-	ICRA] A2+; ISSUER NOT COOPERATING; withdrawn
6	Non fund based	Short term	-	-	-	-	-	ICRA] A2+; ISSUER NOT COOPERATING; withdrawn
7	Unallocated	Long-term/ Short term	-	-	-	-	-	ICRA] A- (stable)/[ICRA] A2+; ISSUER NOT COOPERATING; withdrawn

Complexity level of the rated instrument

ICRA has classified various instruments based on their complexity as "Simple", "Complex" and "Highly Complex". The classification of instruments according to their complexity levels is available on the website www.icra.in

Annexure-1: Instrument details

ISIN No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (RS Crore)	Current Rating and Outlook
NA	Commercial Paper	NA	NA	NA	90.0	[ICRA]A1+
NA	Term Loan (USD million)	25-Aug-2020	NA	14-Mar-2027	15.0	[ICRA]AA- (Stable)

Source: *Company*

Annexure-2: List of entities considered for consolidated analysis

Company Name	Ownership	Consolidation Approach
Pinnacle Life Science Private Limited	100.0%	Full Consolidation
Aarti Speciality Chemicals Limited	100.0%	Full Consolidation
Pinnacle Life Science LLC	100.0%	Full Consolidation
Pinnacle Chile SPA	95.0%	Full Consolidation

Source: *ADL Q3FY2021 Results;* ***Note:*** *ICRA has taken a consolidated view of the parent (ADL), its subsidiaries while assigning the ratings.*

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About ICRA Limited:

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