August 31, 2023

Dhanuka Laboratories Limited: Ratings reaffirmed; rated limits enhanced

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Long-term/ Short-term – Fund-based Working Capital	81.0	91.0	[ICRA]BBB (Stable)/ [ICRA]A3+; Rating reaffirmed/assigned
Short-term, Non-fund Based Working Capital	62.0	62.0	[ICRA]A3+ reaffirmed
Total	**143.0**	**153.0**	

**Instrument details are provided in Annexure-I*

Rationale

For arriving at the ratings for Dhanuka Laboratories Limited (DLL or the company), ICRA has taken a consolidated view of the financials of DLL (standalone), Synmedic Laboratories (Synmedic; a partnership firm involved in manufacturing formulations with DLL's share at 98%), and Orchid Pharma Limited (OPL), which DLL acquired in March 2020 under the Insolvency and Bankruptcy Code (IBC) process, and currently holds ~72.4% stake in it.

The rating reaffirmation factors in the company's improving consolidated business profile primarily through continued revival in the business and financial performance in OPL, which has an established presence in regulated markets in the cephalosporin Active Pharmaceutical Ingredients (APIs) segment. In Q1 FY2024, OPL successfully closed its Qualified Institutional Placement (QIP) of Rs. 400 crore, which has resulted in improved net worth as well as deleveraging as expected with retirement of acquisition related debt. Further, the ratings continue to draw comfort from DLL's established client relationships in the cephalosporins API segment and promoters' extensive experience in the cephalosporins space. The ratings also derive comfort from the track record of financial support from its associate company, Dhanuka Agritech Limited (DAL; rated [ICRA]AA (Stable)/ [ICRA]A1+). The company has announced plans to set up a greenfield facility for manufacturing 7ACA (7-aminocephalosporanic acid), a key raw material for manufacturing cephalosporin antibiotics under OPL's wholly-owned subsidiary (Orchid Biopharma Limited, or OBPL) and will also be adding incremental API capacities in OPL's existing Chennai facility for downstream 7ACA processing. The company is expected to realise substantial backward integration benefits from these facilities in the long term.

The ratings are, however, constrained by ICRA's expectation that the company will witness a moderation in return and credit metrics owing to large capex plans related to greenfield and brownfield capacities over the medium term. While part of the said capex will be funded through QIP proceeds and internal accruals, the company will also be availing sizeable debt, particularly for the 7ACA facility for which funding tie-ups are still awaited. Also owing to the technical complexity and nascent stage of the 7ACA project, there are high project execution risks and the company's ability to successfully commission the plant remains to be seen. In addition, DLL's standalone profit margins continue to remain under pressure owing to raw material price headwinds from a high dependence on China for raw material procurement, competitive pressures in semi-regulated markets and forex fluctuations. The business remains working capital intensive, led by a long receivable period and high inventory requirements.

The Stable outlook on the rating reflects ICRA's expectation that the company will benefit from performance improvements led by OPL with improving utilisation across its oral and enhanced sterile capacities. ICRA takes comfort from DLL's access to financial support from its associate concern, DAL, which can be availed to manage cash flow mismatches.

Key rating drivers and their description

Credit strengths

Leading player in cephalosporin API segment; diversified client portfolio across regulated and semi-regulated markets – The company is a leading manufacturer of cephalosporin APIs and intermediates with a wide portfolio across all five generations of cephalosporin products on consolidated basis. DLL is present in oral cephalosporins, while its subsidiary, OPL, is present in both oral and sterile (injectable) segments. The company has a well-diversified client portfolio across regulated (20% of FY2023 consolidated revenues), domestic (30%), and other semi-regulated/unregulated markets (50%). DLL is also present in the non-cephalosporin segment, which contributed around 7-8% of its consolidated revenues in FY2023.

Part of Dhanuka Group with record of financial support; strong promoters with over 25 years of experience in the pharmaceutical industry – DLL is a part of Dhanuka Group. DLL's promoter, Mr. Manish Dhanuka, has extensive experience of 25 years in pharmaceutical, especially in the cephalosporin segment. Under his leadership, DLL successfully acquired OPL and has been reviving its performance, while having implemented a deleveraging plan through non-core asset sale and equity raise. Moreover, DAL, the flagship company of the Dhanuka Group has a track record of providing financial support to the company. DAL has extended a credit line of Rs. 50 crore to DLL, which is currently unutilised. With managerial and promoter linkages between DLL and DAL, the former enjoys financial flexibility and comfort with support from DAL.

OPL's performance revival has supported consolidated financial profile; 7ACA project to provide backward integration benefits – After the acquisition by DLL in March 2020, OPL has demonstrated continued improvement in performance, supported by improvement in product mix, cost optimisation measures and increased focus on regaining share across markets. Consequently, in FY2023, while OPL clocked a revenue growth of 19%, its margins improved to 12.7% over 9.8% on a YoY basis, despite a challenging environment owing to elevated raw material prices and weak domestic demand. DLL's standalone earnings performance has been modest. Nevertheless, with improving product mix and planned 7ACA capacities, the consolidated margin profile is expected to improve, particularly in the longer term, if the company can successfully implement its 7ACA capacities. These would increase value addition and also reduce import dependence. Moreover, the company would gain from the available PLI incentive, interest subvention and capital subsidies associated with the project.

Improvement in net worth and capital structure – OPL successfully executed its plan to retire acquisition related debt, while reducing DLL's shareholding to below 75% through sale of pending non-core assets (Orchid Tower) in Q4 FY2023 and QIP in Q1 FY2024. As a result, OPL's net worth has improved and gearing has come down due to repayment of term loans and working capital loans.

Credit challenges

Sizeable project risks primarily for 7ACA project; return and credit metrics to be impacted – The company has announced large capex plans of maximum Rs. 850 crore, which includes capex for the greenfield 7ACA project and the brownfield API facility in Alathur (Tamil Nadu) for downstream processing of 7ACA. The said capex will be incurred primarily over FY2024 and FY2025 and will improve the company's operational profile. For the 7ACA project, the company intends to fund a sizeable portion through debt. DLL's consolidated credit profile could witness moderation in the medium term with pressure on return and leverage metrics, pending the project's successful implementation and ramp up. Although the consolidated credit metrics are expected to improve in FY2024 owing to sizeable loan repayment from QIP proceeds, the credit metrics will weaken from FY2025 with expected fresh term loans for the project and the coverage indicators will weaken once the repayment starts for these sizeable loans. ICRA notes that the debt funding required for project is yet to be secured, indicating moderate funding risk. However, the project will be eligible for interest subvention, capital subsidy and PLI benefits, which would subsequently benefit DLL. Further, the project is at a very early stage, indicating high project execution risk. Given the technological complexity, the company's ability to timely secure funding and complete within the timelines and budget, remains crucial. ICRA will continue to monitor the project's development as well as its funding mix.

High import dependence for raw material; susceptible to fluctuations in raw material prices as well as forex rates – The company's operations have high dependence on China for raw material procurement, though through a diversified supplier base. During FY2023, there was significant increase in raw material cost owing to elevated Penicillin prices (a key raw material) and Rupee depreciation, which significantly impacted DLL's standalone margins since it operates in semi-regulated markets with intense competition. OPL managed to improve its margins owing to its favourable product mix (presence in sterile segment) and presence in high margin regulated markets apart from cost optimisation. Although the 7ACA project would bring down its import dependence in the long term, DLL's margins would continue to remain vulnerable to raw material pricing fluctuations as well as forex risk in the near to medium term.

High working capital intensity owing to sizeable contribution from exports and high inventory levels – DLL's working capital intensity continues to remain high at 40-45% on a consolidated basis owing to high debtor days resulting from sizeable exports and the need to maintain high inventory levels due to high price volatility of key raw materials. Thus, the company's working capital requirements are expected to be sizeable, as is characteristic of this business. ICRA notes that the company has adequate working capital limits both at DLL and OPL to meet working capital requirements.

Liquidity position: Adequate

DLL's liquidity position is adequate, characterised by an expectation of stable consolidated retained cash flows of ~Rs. 60-80 crore, unutilised working capital limits of ~Rs. 60-70 crore as of June 2023, on a consolidated basis, and unutilised credit line of Rs. 50 crore from DAL**.** Also, around Rs. 60 crore of net QIP proceeds are available for general corporate purposes, which could also be used to meet OPL's funding requirements. Due to prepayment of term loans, mainly in OPL, the company has modest debt repayment obligations of Rs. 3.0–5.0 crore in FY2024 and Rs. 10.0–11.0 crore in FY2025, on a consolidated basis. However, there are sizeable project capex plans, which are expected to be funded by a mix of QIP proceeds, internal accruals and debt funding; of which debt for the 7ACA project is yet to be secured.

Rating sensitivities

Positive factors – A sustained improvement in earnings along with healthy progress in the planned capex, particularly the greenfield 7ACA project, along with funding tie-ups would be favourably considered for a rating upgrade. Specific metrics for an upgrade would be consolidated total debt/OPBITDA lower than 2.5 times on a sustained basis.

Negative factors – A rating downgrade could be triggered if there is a decline in earnings or liquidity and weakening of the financial risk profile of the consolidated entity on a sustained basis. Also, higher than anticipated debt-funded capex and/or material delays in capex execution leading to worsening of credit metrics could result in a downgrade. Specific metrics for a rating downgrade would be consolidated total debt/OPBITDA higher than 3.5 times on a sustained basis. Further, a decline in financial flexibility available to the entity from its associate concern, DAL, would remain key rating monitorable.

Analytical approach

Analytical Approach	Comments
Applicable rating methodologies	Corporate Credit Rating Methodology Rating Methodology - Pharmaceuticals Rating Approach- Consolidation Rating Approach-Implicit support from Parent or Group
Parent/Group support	The rating assigned to DLL factors in the moderate likelihood of its associate concern, DAL, extending financial support to it because of the need to protect its reputation from the consequences of a Group entity's distress.
Consolidation/Standalone	For arriving at the ratings, ICRA has considered the consolidated financials of DLL. As on March 31, 2023, the company had two subsidiaries, which are enlisted in Annexure-II.

About the company

DLL has been manufacturing and marketing APIs and advanced intermediates of cephalosporin antibiotics, since the commencement of its commercial operations in 1998. The company is promoted by the Dhanuka Group, whose flagship company, Dhanuka Agritech Limited, is rated [ICRA]AA (Stable)/A1+. DLL is a supplier of cephalosporin products to domestic and overseas non-regulated markets through its API facility in Gurgaon (Haryana). The company diversified its portfolio to non-cephalosporin APIs/intermediates through its Keshwana facility in Rajasthan.

DLL's subsidiary, Orchid Pharma is a listed company, which makes cephalosporin APIs and formulations and has significant presence in regulated markets such as the US, Europe and Japan. It has a major API facility in Alathur (Tamil Nadu) with approvals from USFDA and EUGMP. DLL diluted its stake in OPL to 72.4% through an offer for sale in H1 FY2022 and completed a QIP of Rs. 400 crore in Q1 FY2024. OPL applied for the Government of India's PLI scheme for bulk drugs through its newly created, wholly-owned subsidiary, Orchid Biopharma Limited (OBPL), in FY2023, for manufacturing 7ACA. OPL received the approval as per the BSE filing, dated August 16, 2022. The promoters plan to reverse merge DLL with OPL in the near future.

Key financial indicators (audited)

Consolidated	FY2021	FY2022	FY2023
Operating income	821.9	963.2	1113.3
PAT	-116.8	131.4	62.4
OPBDIT/OI	9.3%	7.5%	9.4%
PAT/OI	-14.2%	13.6%	5.6%
Total outside liabilities/Tangible net worth (times)	1.2	0.8	0.8
Total debt/OPBDIT (times)	8.4	5.2	3.6
Interest coverage (times)	1.2	1.8	3.5

PAT: Profit after tax; OPBDIT: Operating profit before depreciation, interest, taxes and amortisation; Amount in Rs crore

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current Rating (FY2024)				Chronology of Rating History for the past 3 years		
		Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)	Date & Rating in	Date & Rating in FY2023	Date & Rating in FY2022	Date & Rating in FY2021
					31-Aug-23	27-May-22	-	25-Mar-21
1	**Fund-based - Working Capital Facilities**	**Long-term/ Short-term**	91.0	-	[ICRA]BBB (Stable)/ [ICRA]A3+	[ICRA]BBB (Stable)/ [ICRA]A3+	-	[ICRA]BBB- (Stable)/ [ICRA]A3
2	**Non-fund Based - Working Capital Facilities**	**Short-term**	62.0	-	[ICRA]A3+	[ICRA]A3+	-	[ICRA]A3

Complexity level of the rated instruments

Instrument	Complexity Indicator
Long Term and Short Term -Fund based	Simple
Short Term Non-Fund-based	Very Simple

The Complexity Indicator refers to the ease with which the returns associated with the rated instrument could be estimated. It does not indicate the risk related to the timely payments on the instrument, which is rather indicated by the instrument's credit rating. It also does not indicate the complexity associated with analysing an entity's financial, business, industry risks or complexity related to the structural, transactional or legal aspects. Details on the complexity levels of the instruments are available on ICRA's website: Click Here

Annexure I: Instrument details

ISIN No	Instrument Name	Date of Issuance / Sanction	Coupon Rate	Maturity Date	Amount Rated (Rs Crore)	Current Rating and Outlook
NA	**Fund-based - Working Capital Facilities**	NA	NA	NA	91.0	[ICRA]BBB (Stable)/ [ICRA] A3+
NA	**Non-fund Based - Working Capital Facilities**	NA	NA	NA	62.0	[ICRA] A3+

Source: Company

[Please click here to view details of lender-wise facilities rated by ICRA]

Annexure II: List of entities considered for consolidated analysis

Company Name	DLL Ownership	Consolidation Approach
Orchid Pharma Limited (OPL)	**72.40%**	**Full Consolidation**
Synmedic Laboratories	**98.00%**	**Equity Method**

Source: company

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About ICRA Limited:

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