

November 17, 2022

Covalent Laboratories Private Limited: Ratings reaffirmed; rated amount enhanced

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Long-term Fund-based – Term loan	22.13	43.74	[ICRA]A- (Stable); reaffirmed/assigned
Long-term – Working Capital Limits	140.00	210.00	[ICRA]A- (Stable); reaffirmed/assigned
Short-term Fund-based Limits	4.00	-	-
Short-term Non-fund based Limits	103.00	83.00	[ICRA]A2+; reaffirmed
Long-term – Unallocated Limits	13.12	-	-
Total	282.25	336.74	

*Instrument details are provided in Annexure-I

Rationale

The rating reaffirmation of Covalent Laboratories Private Limited (CLPL) factors in the company's established operational track record in the manufacturing and sales of cephalosporins class of antibiotic molecules; and extensive experience of its promoters in the industry. CLPL benefits from its established market position as one of the leading manufacturers for its key molecules (Cefixime, Axetil and Cefdinir) in India; and strong relationships with domestic formulation majors. Leveraging on the same, CLPL registered healthy growth of ~23% in its operating income to Rs. 1,802.0 crore in FY2022 from Rs. 1,465.7 crore in FY2021, primarily driven by growth in volumes amid increase in demand for antibiotics following the pandemic. Maintaining the momentum, CLPL reported revenue of ~Rs. 764 crore in 5M FY2023 against ~Rs. 676 crore in the corresponding period in the previous year. Additionally, the ratings factor in CLPL's healthy financial profile as marked by steady internal accrual generation, comfortable capital structure and adequate liquidity profile. CLPL also benefits from sourcing a key raw material and extended credit period from its Group company, Virchow Petrochemicals Private Limited (VPPL)¹, which caters to nearly 35-40% of CLPL's total raw material requirements, thereby providing comfort to its working capital intensity and cash flows.

The ratings, however, continue to remain constrained by high product concentration risk with three key molecules driving around 85% of its total revenues in FY2022. CLPL's operating margins (OPM) also remain vulnerable to raw material costs and limited pricing flexibility owing to dependence on mature molecules. This was also demonstrated by the decline in OPM in FY2022, resulting in some moderation in the company's debt coverage indicators. Moreover, while OPM has remained moderate in H1 FY2023, the same is expected to improve in H2 FY2023 with some stability in key raw material prices and anticipated increase in average realisations.

Further, CLPL's profitability remains vulnerable to forex fluctuations as it imports around 40% of its total raw material. However, the company is focused on reducing its overall dependence on imports by installing new production capacities, thus creating import substitutes within CLPL, which is expected to support its OPM and gradually enable CLPL to become a net exporter. The operations of the company also remain exposed to regulatory risks arising out of the scrutiny of various regulatory agencies.

The Stable outlook reflects ICRA's opinion that CLPL will continue to benefit from its established position in the domestic active pharmaceutical ingredient (API) market and adequate liquidity position, which continue to support its credit profile.

¹ Rated [ICRA]A+ (Stable)

Key rating drivers and their description

Credit strengths

Established operational track record of operations and extensive experience of promoters in the industry; financial flexibility enhanced by being part of the Virchow Group – CLPL is part of the Virchow Group with an extensive experience of around four decades in the API industry. The Group consists of six independent API, one bio-pharmaceutical and two drug intermediate companies. Furthermore, CLPL has an established presence of over two decades in manufacturing APIs and intermediates of cephalosporins. CLPL purchases around 40% of its raw material from Group company, VPPL, which provides it an extended credit period of 120-130 days to support its credit cycle.

High market share for key molecules – CLPL has a high market share in the domestic market for its key molecules, i.e., Cefixime, Proxetil, Axetil and Cefdinir, and is also increasing efforts to increase its presence in the exports market. Though exports declined in FY2022 due to moderation of demand in some countries during the pandemic, CLPL has witnessed a continuous increase in exports over the years, which are expected to grow further, going forward. The company sells to unregulated, semi-regulated as well as regulated markets; although sales to regulated markets are primarily via Indian formulation companies.

Established presence in domestic market supported by reputed customer base – CLPL is an established company in the cephalosporin API space due to its reputable track record and long-term relationships with leading domestic formulation companies, aiding recurring order inflow. CLPL's top five customers accounted for ~21% of its total sales in FY2022 against ~24% in FY2021. CLPL has manufacturing approvals from the United States Food and Drug Association (USFDA), European Union Good Manufacturing Practices (EU-GMP) and World Health Organization Good Manufacturing Practices (WHO-GMP), among others.

Healthy financial profile – Though the decline in operating margins resulted in some moderation in the coverage indicators in FY2022, CLPL's overall financial profile remained healthy marked by strong capitalisation and coverage indicators, aided by steady internal accrual generation. The gearing, TD/OPBITDA, interest coverage and TOL/TNW were recorded at 0.4 time, 1.6 times, 11.6 times and 1.4 times, respectively, in FY2022 over 0.4 time, 1.2 times, 11.5 times and 1.4 times, respectively, in FY2021. With only moderate addition in debt towards capex funding expected over the medium term, CLPL's financial profile is expected to remain healthy on the back of steady business performance.

Credit challenges

High product concentration on cephalosporins – CLPL continues to derive a major proportion of its revenues from its three key molecules, i.e., Cefixime, Axetil and Proxetil, contributing 80-85% to its total revenues over the years. In FY2022, the three molecules generated 85% of its total revenue. Cefixime is the major revenue driver with a 53% share of total revenues in FY2022, followed by Axetil (19%) and Proxetil (14%). The revenue shares of other oral and sterile cephalosporins continue to remain negligible.

OPM vulnerable to movement in raw material costs; limited pricing flexibility owing to dependence on mature molecules – CLPL's operating margins declined to 5.4% in FY2022 from 9.0% in FY2021 due to rise in raw material prices, which are partially passed on to customers with a lag of 3–6 months. The margins were further impacted by the rise of power and fuel costs and freight charges due to various geopolitical events. The pressure on margins continued over H1 FY2023 due to continued high input costs. Owing to a product profile of matured molecules, CLPL has limited pricing flexibility and its margins are expected to remain vulnerable to volatility in raw material prices, going forward.

Profitability exposed to forex fluctuations – CLPL's profitability remains vulnerable to forex fluctuations, given its dependence on imports for raw materials. In FY2022, imports stood at around 41% of the total raw material costs, majorly from China. While the company has no formal hedging policy, the risk is mitigated to a large extent by a natural hedge through exports. While it is a net importer currently, it endeavours to turn into a net exporter over the medium term. To support this, CLPL is reducing its overall dependence on imports by installing new production capacities, thus creating import substitutes within CLPL. It has already commissioned a new manufacturing block that provides a substitute of an intermediate of Cefixime and is

investing in another manufacturing block to be used for producing a substitute of an intermediate for Axetil. This is also expected to support the margins while reducing dependence on imports in the medium to long-term.

Exposure to regulatory risks – Akin to other players in the industry, CLPL's operations continue to remain exposed to regulatory risks of greater scrutiny by regulatory agencies like US FDA, EU GMP and WHO GMP, among others. It also remains vulnerable to any regulatory changes impacting its business or the industry.

Liquidity position: Adequate

CLPL's liquidity is adequate, supported by steady internal accrual generation, unencumbered cash and bank balance of Rs. 7.0 crore as on March 31, 2022, and Rs. 20.9 crore as on August 31, 2022. The increase in cash balances as on August 31, 2022, is because of advances from customers and disbursement of term loan, which is expected to normalise during the year. The liquidity is additionally supported by its unutilised bank facilities of ~Rs. 100 crore as on August 31, 2022. CLPL has a capex commitment of ~Rs. 40 crore over FY2023 and FY2024, to be financed by debt of Rs. 30 crore, which has already been partially drawn down. CLPL has moderate repayment obligations of ~Rs. 7-12 crore p.a. in FY2023 and FY2024 and its internal accrual generation is expected to be more than sufficient to service the same.

Rating sensitivities

Positive factors – The rating may be upgraded if there is a sustained improvement in the revenues and profitability of the company across its key molecules, leading to sustained improvement in return indicators and further strengthening of its financial risk profile. Specific credit metrics that could lead to a rating upgrade include Total Debt/OPBITDA below 1.5 times on a sustained basis, and TOL/TNW lesser than 1.2 times on a sustained basis.

Negative factors – Negative pressure on CLPL's rating could arise with deterioration in its credit metrics, owing to sustained reduction in its revenue growth and profitability, debt-funded capex or elongation of its working capital cycle. Specific credit metrics that could lead to a rating downgrade include Total Debt/OPBITDA exceeding 2.3 times and a weakening in TOL/TNW, greater than 1.5 times on a sustained basis.

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	Standalone

About the company

Incorporated in September 2002 by Mr. Madireddy Narayana Reddy and his associates, CLPL specialises in manufacturing APIs and intermediates for cephalosporins in the therapeutic segment of the beta-lactamase antibiotic. The key products of CLPL include APIs for four cephalosporin drugs—Cefixime, Axetile, Proxetile and Cefdinir. CLPL has a single manufacturing facility in the Medak district of Hyderabad (Telangana), with an installed production capacity of 1,844 metric tonne per annum (MTPA) of oral and sterile cephalosporin APIs. The facility is USFDA, EU-GMP, WHO-GMP, and ISO 14001-2004 certified. CLPL is a part of the Hyderabad-based Virchow Group, which has interests primarily in pharmaceutical businesses.

Key financial indicators (audited)

CLPL	FY2021	FY2022
Operating income	1465.7	1802.0
PAT	73.0	52.5
OPBDIT/OI	9.0%	5.4%
PAT/OI	5.0%	2.9%
Total outside liabilities/Tangible net worth (times)	1.4	1.4
Total debt/OPBDIT (times)	1.2	1.6
Interest coverage (times)	11.5	11.6

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 (FY2023)			Chronology of Rating History for the past 3 years			
		Type	Amount Rated (Rs. crore)	Amount Outstanding (Rs. crore)*	Date & Rating in FY2023	Date & Rating in FY2022	Date & Rating in FY2021	Date & Rating in FY2020
					Nov 17, 2022	Oct 6, 2021	Oct 12, 2020	Nov 07, 2019
1	Fund-based Term Loan	Long term	43.74	24.64	[ICRA]A- (Stable)	[ICRA]A- (Stable)	[ICRA]A- (Stable)	[ICRA]BBB+ (Stable)
2	Working Capital Limits	Long term	210.00	-	[ICRA]A- (Stable)	[ICRA]A- (Stable)	[ICRA]A- (Stable)	[ICRA]BBB+ (Stable)
3	Fund-based Limits	Short term	-	-	-	[ICRA]A2+	[ICRA]A2+	[ICRA]A2
4	Non-fund Based Limits	Short term	83.00	-	[ICRA]A2+	[ICRA]A2+	[ICRA]A2+	[ICRA]A2
5	Unallocated	Long term	-	-	-	[ICRA]A- (Stable)	[ICRA]A- (Stable)	[ICRA]BBB+ (Stable)

*as on August 31, 2022

Complexity level of the rated instruments

Instrument	Complexity Indicator
Long-term fund-based – Term Loan	Simple
Long-term – working capital limits	Simple
Short-term Non-fund based limits	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	Instrument Name	Date of Issuance	Coupon Rate	Maturity	Amount Rated (Rs. crore)	Current Rating and Outlook
NA	Term Loan-I	June 2018	NA	June 2024	13.74	[ICRA]A- (Stable)
NA	Term Loan-II	June 2022	NA	June 2027	30.00	[ICRA]A- (Stable)
NA	Working Capital Limits	NA	NA	NA	210.00	[ICRA]A- (Stable)
NA	Non-fund based Limits	NA	NA	NA	83.00	[ICRA]A2+

Source: Company

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

Annexure II: List of entities considered for consolidated analysis – Not applicable

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