March 25, 2021

Dhanuka Laboratories Limited: Ratings reaffirmed; removed from watch with negative implications; Stable outlook assigned

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Fund-based Working Capital Facilities	41.00	81.00	[ICRA]BBB- /[ICRA]A3 reaffirmed; ratings removed from watch with negative implications; Stable outlook assigned
Non-fund Based Working Capital Facilities	62.00	62.00	[ICRA]A3 reaffirmed; ratings removed from watch with negative implications
Fund-based and Non-fund Based - Working Capital Facilities	20.00	0.00	-
Non-fund Based Facilities	50.00	0.00	-
Total	**173.00**	**143.00**	

**Instrument details are provided in Annexure-1*

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 the manufacturing of formulations with DLL's share at 98%, and Orchid Pharma Limited, which DLL acquired in March 2020 under the Insolvency and Bankruptcy Code (IBC)process.

The ratings were placed on watch with negative implications in July 2019, following the approval of DLL’s resolution plan for Orchid Pharma Limited by the National Company Law Tribunal (NCLT), under the IBC. As the acquisition of Orchid Pharma is now completed, the ratings have been removed from watch with negative implications. The rating reaffirmation factors in DLL’s established relationships with anti-bacterial formulation companies in the Cephalosporin active pharmaceutical ingredient (API) segment, its diversified product profile, successful acquisition of Orchid Pharma as well as strong financial flexibility and support from its associate company, Dhanuka Agritech Limited (DAL) (rated [ICRA] AA-(Positive)/[ICRA]A1+). ICRA favourably considers the company's increasing presence in the non-Cephalosporin APIs and intermediates segment, which have enhanced its product profile and is likely to supplement its revenue growth prospects over the medium term. The non-Cephalosporin segment currently drives around 16-25% of the company’s revenues on a standalone basis and lends support to the company’s profitability through some of its high realisation products.

With the acquisition of Orchid Pharma, the company’s business profile has strengthened significantly as Orchid Pharma is a major player in Cephalosporin APIs/ intermediates with significant presence in regulated markets such as the US, the EU and Japan. DLL, which mainly supplies APIs to domestic and semi-regulated markets like Pakistan, Bangladesh, Turkey, etc, would get access to the regulated markets to launch its products, thus providing a plethora of cross selling opportunities. The company would also share synergies with Orchid Pharma on the API manufacturing technology front and could capitalise on Orchid’s cutting edge R&D infrastructure for new product development and its huge portfolio of active patents and drug filings to expand its geographic footprint.

Due to the impact of the Covid-19 pandemic in FY2021, the demand for antibiotics and anti-bacterial drugs fell significantly as there were low patient footfalls in the hospitals for medical procedures. This resulted in decline in Cephalosporin API sales across semi-regulated and regulated markets, thus impacting API revenues for both DLL and Orchid Pharma. However, sales for certain non-Cephalosporin APIs, such as Montelukast, which are used primarily for cough and fever, improved significantly In FY2021. With the company's increasing focus on APIs with high average realisation, the operating profitability improved to 7.9% in FY2020 and 10.6% in H1 FY2021 compared to 4.1% in FY2019. The ramp-up of Synmedic facilities was slower than anticipated as there was delay in getting the regulatory approval from Vietnam for site-transfer of Faridabad plant to Keshwana (Rajasthan) plant. Due to cost reduction initiatives taken by DLL's management, Orchid Pharma reported OPM of 17% in Q1 and Q2 FY2021. In Q3 FY2021, due to decline in antibiotic demand in regulated markets, which were its main markets, a lot of production was sold in non-regulated markets, resulting in significant decline in gross margins, resulting in 11% OPM for the 9M FY2021 period.

The acquisition outlay of Rs. 610 crore for Orchid Pharma was funded by a term loan of Rs. 427 crore (on Orchid's books), unsecured debt of Rs. 143 crore raised from promoters and promoter entities through Optionally Convertible Debentures (OCDs) (on DLL's books) and equity infusion of Rs. 40 crore by promoters. With increase in debt level, the interest costs and debt repayments increased significantly to Rs. 50-55 crore and Rs. 90-100 crore, respectively, resulting in stretched coverage indicators. The working capital requirements also increased significantly with the acquisition and the company has already requested for additional working capital of Rs. 75 crore for Orchid Pharma, which is under sanction process. Although the acquisition has resulted in increased debt levels, the company is planning to deleverage Orchid Pharma through the sale of its non-core assets, such as its formulation unit in Irrungattukottai (Tamil Nadu) / IKKT plant and Orchid Towers in Chennai, which would reduce the external debt by Rs. 180-220 crore by FY2022-FY2023. DLL also has to reduce its equity stake in Orchid Pharma by 8% as mandated by SEBI, which would bring additional funds of Rs. 80-90 crore and could be used to pay off the debt. ICRA would continue to monitor DLL's non-core asset monetisation plans and take appropriate rating actions.

The Stable outlook on the rating reflects ICRA's expectation that an improvement in the performance of Orchid Pharma, coupled with a stable operational performance for DLL benefitting from its established relationships with its customers, would help it maintain a stable credit profile. While the progress on monetisation of non-core assets would remain a key rating sensitivity, ICRA expects access to financial support from associate concern, DAL, to help DLL meet its debt servicing requirements in a timely manner.

Key rating drivers and their description

Credit strengths

Strong financial support from associate concern, DAL – DAL (rated [ICRA]AA- (Positive) /[ICRA]A1+), an associate company of DLL, is the strongest rated company in the Dhanuka Group. DAL's directors, Mr. MK Dhanuka and Mr. Arun Kumar Dhanuka, also sit on DLL's board. There is a long track record of DAL providing financial support to the company. In FY2020, DAL enhanced the credit line to Rs. 50 crore for Dhanuka Labs from Rs. 25 crore earlier. DAL's promoters even pledged a part of their shareholding in DAL, to raise debt for part funding for the acquisition of Orchid Pharma. However, there was a change in the funding mix of the acquisition later and, accordingly, all the DAL's shares pledged were released. Thus, the company's enjoys strong financial flexibility and comfort with support from DAL.

Established relationships with customers in cephalosporin segment; diversification into non-cephalosporin API/ intermediates helped enhance product profile – DLL manufactures mature Cephalosporin APIs and intermediates that are sold to pharmaceutical formulators, who convert these into various dosage forms, viz. capsules, tablets and dry syrups. The company's diversified product profile helps tide over the fluctuations in raw material prices and the demand for mature molecules. DLL has maintained strong relationships with its clientele in both the domestic and export markets over the years. It has a well-diversified customer base with the top five customers contributing ~35% to the revenues. To further diversify its product profile, the company set up a new plant in Keshwana (Rajasthan), which became operational in December 2017, for manufacturing non-Cephalosporin APIs. The facility has ramped up production over the past two years, and constitutes almost 16-25% of the total DLL (standalone) revenues. The key APIs manufactured under the non-Cephalosporin segment are Montelukast, Telmisartan and Levetiracetam. In addition to the domestic market, the company is focussed on gaining business from semi-regulated markets over the medium term.

Acquisition of Orchid Pharma to provide access to regulated markets and API manufacturing technology; ramp-up of facilities to support revenue growth – DLL mainly exports ~50% of its API products to non-regulated overseas markets such as South Korea, China, Pakistan, Bangladesh, Vietnam, Turkey, etc, which are fettered with high competitive intensity and lower margins. The acquisition of Orchid Pharma, an export oriented unit (EOU) with significant presence in regulated markets, such as the US, the EU, Japan, etc, provides significant geographic diversification to DLL on a consolidated basis. DLL would also gain synergies on the API manufacturing technology front considering Orchid has state-of-the-art and GLP compliant R&D infrastructure for process research and pharmaceutical research near Chennai. The total size of patent portfolios with Orchid Pharma was 196 as of March 31, 2020, out of which 48 patents are active indicating strong R&D capabilities.. Orchid Pharma's manufacturing facilities are currently operating at capacity utilisation of ~40%, clocking annual revenues of around Rs. 500-550 crore. Thus, the company has significant installed manufacturing capacity to double its revenues without incurring any additional growth capex.

Focus on high average realisation APIs supported operating profitability in FY2020 and FY2021 YTD; expected significant OPBITDA contribution with ramp-up of Orchid's facilities – The company has increased its focus on products with high average realisation rates both in Cephalosporin and non-Cephalosporin segments, resulting in improvement in DLL's (standalone) operating profitability to 7.9% (PY: 4.1%) in FY2020. The prices of some non-Cephalosporin products, such as Montelukast, used primarily for cough and fever, increased significantly in FY2021, thereby aiding OPM to ~10.5% for H1 FY2021 (provisional financials). Since Orchid Pharma exports almost 80-85% of its products to regulated markets, it witnesses healthy gross margins of around 45-55% compared to 20-25% for DLL, which mainly exports to non-regulated markets. Following the acquisition, OPL reported positive OPBITDA of Rs. 39.4 crore during H1 FY2021 with OPM of 17%, although it dropped to 11% for 9M FY2021 as a lot of its production was sold to non-regulated markets in Q3 FY2021 due to the drop in antibiotic demand in regulated markets, such as Europe. Thus, as antibiotic demand improves in regulated markets, OPM is expected to improve considering its contribution of ~50% to DLL's (consolidated) revenues.

Credit challenges

Decline in Cephalosporin API revenues in FY2021 due to Covid-19 impact on antibiotic demand in regulated as well as non-regulated markets – Due to the onset of the Covid-19 pandemic, there was significant decline in the medical operations and surgeries in hospitals, which impacted the demand of antibiotics and anti-bacterial drugs, the main consumers of Cephalosporin APIs. One of DLL's key products, Ceftibuten, which drove 18% of revenues in FY2020 and is mainly exported to Turkey and Bangladesh, performed the worst in FY2021, resulting in decline in DLL's sales to Rs. 132.7 crore in H1 FY2021 (FY2020: 207 crore). The impact was also witnessed in regulated markets, such as Europe, which had lockdowns till Q3 FY2021. As a result, a lot of Orchid Pharma's API production was sold at lower realisation in non-regulated markets, resulting in significant drop in GM. Although antibiotic demand started picking up slowly from Q4 in Europe, it would take a few quarters to reach the pre-Covid levels.

Acquisition of Orchid Pharma leads to enhanced borrowings; sale of non-core assets remains key for deleveraging plans – With the acquisition of Orchid Pharma, DLL added Rs. 427 crore of external term debt to DLL's consolidated profile; the total debt on the consolidated balance sheet as of March 31, 2020 was Rs. 765.5 crore. Due to increase in debt level, the interest costs increased to Rs. 50-55 crore (PY: 18.1 crore) and debt repayments increased to Rs. 90-100 crore from FY2022 onwards. The company is aggressively pursuing plans to monetise Orchid Pharma's non-core assets, such as the IKKT formulation plant and Orchid Tower (in line with the resolution plan for Orchid Pharma) to bring down the debt levels by Rs. 180-220 crore by FY2022-FY2023. The sale of non-core assets would remain a key monitorable.

Liquidity position: Adequate

DLL's liquidity position is adequate, characterised by an expectation of stable retained cash flows of ~Rs. 40-60 crore on a consolidated basis annually, moderate utilisation of working capital limits (buffer of ~Rs. 10-15 crore), additional working capital facility of Rs. 75 crore under process and low capex requirement of ~Rs. 10-15 crore over the next three years. DLL is expected to have annual debt repayments of ~Rs. 90-100 crore/annum over FY2022-FY2023, with its cash flows likely to be adequate to help repay the same in a timely manner. The company is expected to earn funds from the monetisation of non-core assets such as its IKKT formulation plant and Orchid Tower, which would contribute around Rs. 180-220 crore and would be used for pre-payment of its debt. There would also be 8% stake sale by DLL's promoters through OFS before September 2020, as mandated by SEBI, which is expected to bring additional funds of Rs. 80-90 crore in FY2022. The track record of funding support from the promoters and financial flexibility in the form of access to credit line from an associate concern, DAL, provides comfort.

Rating sensitivities

Positive factors – A faster-than-expected ramp up in scale of operations of the Orchid API facilities, or higher than expected receipt of funds from the sale of non-core assets, resulting in strengthening of the consolidated entity's credit profile, would be favourably considered for a rating upgrade.

Negative factors – A rating downgrade could be triggered if the ramp up in Orchid Pharma's and Synmedic's facilities is slower than expected, weakening the financial risk profile of the entity. Also, the inability to deleverage the company through the monetisation of non-core assets or Orchid Pharma would negatively impact the credit profile. Further, a decline in financial flexibility available to the entity from its associate concern, DAL, would remain a key rating monitorable.

Analytical approach

Analytical Approach	Comments
Applicable Rating Methodologies	Corporate Credit Rating Methodology Rating Methodology for Entities in the Pharmaceutical Industry Impact of Parent or Group Support on an Issuer's Credit Rating
Parent/Group Support	The rating assigned to DLL factors in the very high likelihood of its associate concern, DAL, extending financial support to it because of the close business linkages between them. ICRA also expects DAL to be willing to extend financial support to DLL out of its 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, 2020, the company had two subsidiaries that are enlisted in Annexure-2.

About the company

DLL has been involved in 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- (positive) /[ICRA]A1+. DLL is a supplier of Cephalosporin products to domestic and overseas non-regulated markets, such as Pakistan, Bangladesh, Turkey, South Korea, China, etc, through its manufacturing facility in Gurgaon (Haryana). The company diversified its portfolio to non-Cephalosporin APIs/ intermediates through its Keshwana facility in Rajasthan.

The company completed the acquisition of Orchid Pharma Limited in March 2020 under the IBC process. Established in 1992, as an EOU, Orchid Pharma is a listed company that makes Cephalosporin APIs and formulations, with significant presence in regulated markets, such as the US, the EU, Japan, etc. Orchid Pharma has two major manufacturing facilities—an API facility in Alathur (Tamil Nadu) and a finished dosage form (FDF)/ formulations facility (IKKT unit) in Irrungattukottai (Tamil Nadu). Apart from operating in the API segment, DLL is present in formulation segments through Synmedic, which was acquired by DLL in 2013. At present, Synmedic operates a manufacturing facility in Faridabad (Haryana) and mainly sells its products to south-east Asian nations such as Vietnam, The Philippines, Cambodia, etc. Synmedic has also set up another plant in Rajasthan to increase its manufacturing capacity for formulations.

Key financial indicators (audited)

DLL Consolidated	FY2019	FY2020*
Operating Income (Rs. crore)	438.4	436.0
PAT (Rs. crore)	4.7	2.4
OPBDIT/OI (%)	3.9%	7.4%
PAT/OI (%)	1.1%	0.5%
Total Outside Liabilities/Tangible Net Worth (times)	2.3	1.0
Total Debt/OPBDIT (times)	10.5	23.6
Interest Coverage (times)	1.1	2.3

PAT: Profit after Tax; OPBDIT: Operating Profit before Depreciation, Interest, Taxes and Amortisation
Source: DLL, ICRA research
** Profit and Loss statement of Orchid Pharma not considered as acquisition happened in March 2020*

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
					25-Mar-21	18-Dec-19	2-Jul-19	25-Feb-19	24-Jan-19	18-Jan-18
1	Fund-based - Working Capital Facilities	Long Term/ Short Term	81.0	-	[ICRA]BBB- (Stable)/ [ICRA]A3	[ICRA]BBB- @ / [ICRA]A3 @	[ICRA]BBB- @ / [ICRA]A3 @	[ICRA]BBB- (Stable)/ [ICRA]A3	[ICRA]BBB- (Stable)/ [ICRA]A3	[ICRA]BBB+ (Negative)/ [ICRA]A2
2	Non-fund Based - Working Capital Facilities	Short Term	62.0	-	[ICRA]A3	[ICRA]A3 @	[ICRA]A3 @	[ICRA]A3	[ICRA]A3	[ICRA]A2
3	Fund-based and Non-fund Based - Working Capital Facilities	Long Term/ Short Term	0.0	-	-	[ICRA]A3 @	[ICRA]A3 @	[ICRA]A3	[ICRA]A3	[ICRA]A2
4	Non-fund Based Facilities	Long Term	0.0	-	-	[ICRA]BBB- @				

@ Under watch with developing implications

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	Fund-based - Working Capital Facilities	NA	NA	FY2024	81.0	[ICRA]BBB- (Stable)/ [ICRA]A3
NA	Non-fund Based - Working Capital Facilities	NA	NA	FY2024	62.0	[ICRA]A3

Source: *Company*

Annexure-2: List of entities considered for consolidated analysis

Company Name	DLL Ownership	Consolidation Approach
Synmedic Laboratories	98.00% (rated entity)	Full Consolidation
Orchid Pharma Limited	98.00%	Full Consolidation

Source: *DLL annual report*

Note: *ICRA has taken a consolidated view of the parent (DLL), its subsidiaries and associates while assigning the ratings.*

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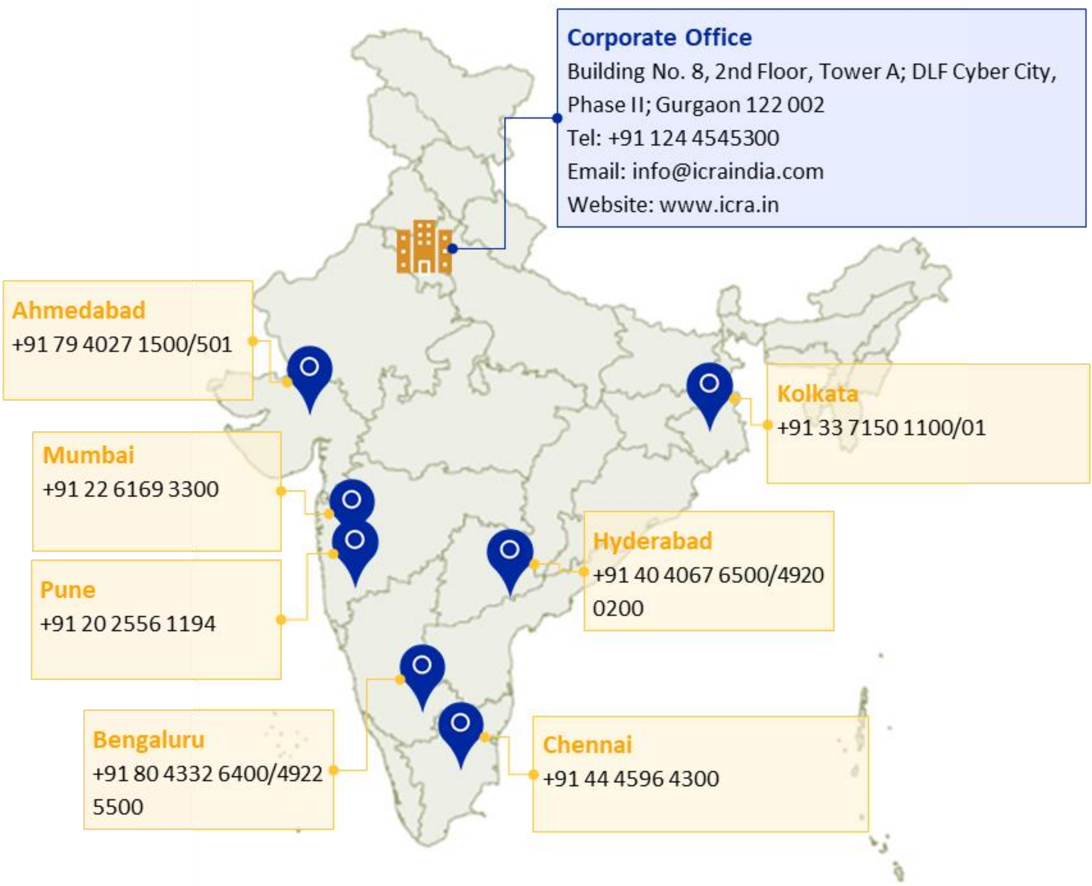

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