

April 22, 2021

Andhra Organics Limited: Ratings reaffirmed

Summary of rating action

| Instrument* | Previous Rated Amount (Rs. crore) | Current Rated Amount (Rs. crore) | Rating Action |
|---|-----------------------------------|----------------------------------|------------------------------|
| Fund based – Working capital facilities | 7.50 | 7.50 | [ICRA]A+(Stable); reaffirmed |
| Non-fund based limits | 1.50 | 1.50 | [ICRA]A1+; reaffirmed |
| Total | 9.00 | 9.00 | |

*Instrument details are provided in Annexure-1

Rationale

For arriving at the ratings, ICRA continues to take a consolidated view of Virchow Laboratories Limited (VLL) and Andhra Organics Limited (AOL, referred to as the Group hereafter), given its parent subsidiary relationship, same line of business operations, presence of inter-company transactions and overlapping product portfolio.

The reaffirmed ratings derive comfort from the Group's established market position across key molecules, strong financial profile and liquidity. The ratings consider the vast experience of the promoters in manufacturing and marketing of molecules in the pharmaceutical industry, being a part of the Virchow Group. The Group is a leading global supplier of sulfamethoxazole (SMX), holds an established presence in CIS hydroxy lactum (CIS lactum) and trimethoprim (TMP) and a growing presence in sildenafil citrate. The Group derives significant operational efficiencies from large installed capacities and backward integration of related chemicals that protect the company's profitability to an extent. The client concentration risk remains low with the top three customers contributing to 11.5% of the revenues in FY2020, coupled with a diversified geographical presence in regulated, semi-regulated and domestic markets.

The Group's revenues declined by 14.0% YoY in FY2020, because of de-growth in TMP and SMX volumes. The reduction in volume was a result of lower demand offtake for both molecules, coupled with production bottlenecks in the TMP unit. These bottlenecks were resolved to an extent in H2 FY2021. The dip in FY2020 was partly offset by a healthy scale up in sildenafil citrate volumes. ICRA expects a healthy revenue growth in FY2021, driven by recovery in demand offtake across molecules as seen in 9M FY2021. The FY2021 operating and net margins are expected to improve, led by improved realisations and reduction in raw material prices during the year.

The Group is undertaking sizeable capex of Rs. 325.0 crore in FY2022-FY2023, majority of which is targeted towards new product launches. With an average gestation period of 12-24 months, achieving the desired levels of profitability and accruals for the proposed capex remains a key sensitivity. Despite sizeable capex plans, the Group's capital structure and coverage indicators are likely to remain comfortable, supported by healthy accruals, use of internal resources for funding capex and low reliance on external debt.

The ratings are constrained by its high working capital intensity and continued high product concentration, coupled with dependence on mature molecules, which restricts growth prospects. Therefore, diversification into new molecules remains the key for the Group. The profitability remains exposed to volatility in raw material prices and limited pricing flexibility because of its dependence on mature molecules. The Group has limited reliance on imports for raw material requirements; its sizeable exports mitigate the forex risk to some extent. Further, the Group remains exposed to regulatory risks including price control, anti-dumping duties, pollution control and product quality risks inherent in the industry.

The Stable outlook reflects ICRA's opinion that the Group will continue to derive comfort from the vast experience of its promoters, along with its leading and established market position across products. Healthy accruals, strong liquidity profile and low reliance on external debt contribute to the company's healthy financial profile.

Key rating drivers and their description

Credit strengths

Established market presence in key molecules with backward-integrated facilities; part of renowned Virchow Group – VLL and AOL are a part of the Virchow Group, which has a strong track record of acquiring significant market share for its key products due to its cost competitiveness. The Group remains the leading global producer of SMX, benefitting from its large production capacities and backward integration, which results in lower cost of manufacturing. It has an established presence in CIS lactum and TMP, growing presence in sildenafil citrate and a focus to diversify and grow in sartans and sulphur-based antibiotics.

Diversified geographical presence and wide customer base – Exports contributed to 45.8% of the revenues in FY2020, with sales distributed across regulated, semi-regulated (Asian and African) and domestic markets. VLL primarily caters to the regulated and semi-regulated markets, whereas AOL caters to demand from domestic, semi-regulated and limited regulated markets. The Group has an established and reputed customer base comprising traders and end-user pharmaceutical companies, with the top three customers accounting for 11.5% of sales in FY2020.

Healthy profitability indicators – The Group derives significant operational efficiencies from large installed capacities and backward integration of related chemicals that protect the company's profitability to an extent. The operating and net margins improved to 18.9% and 15.1%, respectively, in FY2020 from 15.1% and 10.4%, respectively, in FY2019. The improvement was led by improved contribution margins for SMX and CIS Lactum in FY2020. The FY2021 operating and net margins are expected to benefit from improved realisations and reduction in raw material prices during the year. The consolidated profit before tax (PBT) margins stood at 24.0% in 9M FY2021 compared to 18.8% in FY2020. However, the profitability remains exposed to volatility in raw material prices and limited pricing flexibility because of its dependence on mature molecules.

Strong capital structure and coverage indicators despite share buyback and significant near-term capex – The Group's capital structure and coverage metrics remained healthy, driven by healthy accruals and low dependence on long-term funding. Its TD/OPBITDA, interest coverage and TOL/TNW remained robust at 0.3 times, 164.6 times and 0.2 times in FY2020, respectively, and is expected to remain comfortable in FY2021. The capital structure remains strong, even with share buyback of Rs. 39.7 crore in FY2020 and Rs. 55.4 crore in FY2019. Despite sizeable capex plans of ~Rs. 325.0 crore in FY2022-FY2023, the Group's capital structure and coverage indicators are likely to remain comfortable due to healthy accruals internal capex funding and low reliance on external debt.

Credit challenges

High product concentration risks – The Group faces high product concentration with top three products contributing to 75.0% of the revenue profile. Dependence on SMX, its key molecule, accounted for 47.6% of the Group's revenues in FY2020. While it has reduced from its peak levels of 79.6% in FY2013 with the launch of other products such as TMP (15.4% of FY2020 revenues), CIS lactum (12.0% of FY2020 revenues) and sildenafil citrate (3.3% of FY2020 revenues), high concentration towards mature molecules has limited the Group's revenue growth potential. Therefore, diversification into new molecules remains the key for its future growth prospects. It is undertaking sizeable capex in FY2022-FY2023, most of which is targeted towards new product launches. The same is likely to commercialise from FY2023 onwards.

High working capital intensity – The working capital intensity deteriorated to 45.5% in FY2020 from 37.7% in FY2019 because of a sizeable increase in receivable and inventory days. While the receivable days range between 60-120 days for domestic and export sales, it increased on March 31, 2020 due to large sales in Q4 FY2020 and the impact of pandemic-induced lockdown during the last few days of March 2020. The increase in inventory levels on March 31, 2020 was also a result of unsold stock because of the pandemic-induced lockdowns. While some creditors were paid in advance to ensure timely deliveries, some payments to customers were extended amid the pandemic. The working capital cycle normalised for both the entities in 9M FY2021. However, given the launch of new products, the Group is likely to extend higher credit to onboard new customers, leading to similar working capital intensity (in line with FY2020) going forward.

Profitability exposed to regulatory risks, fluctuations in raw material prices and limited pricing flexibility because of mature molecule portfolio – The company is exposed to regulatory risks such as manufacturing facility approvals and local manufacturing requirement by various Government authorities, as a part of a regulated industry amid an evolving landscape. It is also exposed to volatility in raw material prices and limited pricing flexibility because of its dependence on mature molecules. The Group has limited reliance on imports for raw material requirements, but its sizeable exports mitigate the foreign exchange fluctuation risk to some extent. The downside risk is mitigated to an extent by its leading market position and backward integration into related chemicals that protect its profitability.

Liquidity position: Strong

The Group’s liquidity is strong with healthy expected yearly accruals of Rs. 90.0- Rs. 100.0 crore and expected fund flow from operations of Rs. 85.0-100.0 core. The cash flows generated are utilised to meet the working capital requirements, capex funding and payouts to promoters in the form of dividends or share buyback, with the rest being parked in liquid investments and bank deposits. The liquidity is supported by the healthy cash and bank balance of Rs. 149.5 crore and investment in mutual funds of Rs. 119.3 crore as on December 31, 2020. Further, the Group’s average working capital utilisation remains low at 12.2% for the 12-month period that ended in December 2020. The Group has no long-term debt. It has sizeable capex commitment of ~Rs. 325.0 crore in FY2022-FY2023 to diversify its product portfolio, financed by internal accruals and existing cash and cash equivalents.

Rating sensitivities

Positive factors – ICRA could upgrade the Group’s ratings if it achieves higher product portfolio diversification, thereby reducing its dependence on mature molecules, along with a meaningful scale up in capacities for new molecules and maintaining an established market position across its key molecules.

Negative factors – Negative pressure on the ratings could arise if the company’s revenues and operating profitability decline significantly or if there is any major debt-funded capital expenditure, increase in working capital intensity or higher-than-expected withdrawals from promoters without corresponding surpluses resulting in an adverse impact on the company’s liquidity profile. Specific credit metrics that could lead to a downgrade is TD/OPBITDA exceeding 2.0 times on a sustained basis.

Analytical approach

| Analytical Approach | Comments |
|---------------------------------|---|
| Applicable Rating Methodologies | Corporate Credit Rating Methodology Rating Methodology for Entities in the Pharmaceuticals Industry |
| Parent/Group Support | Not Applicable |
| Consolidation/Standalone | For arriving at the ratings, ICRA has consolidated the financials of VLL and AOL (as mentioned in Annexure-2) given the close business and managerial linkages shared among them. |

About the company

AOL is a 100% subsidiary of VLL. VLL was incorporated in 1982, VLL is the flagship company of the Hyderabad-based Virchow Group, promoted by Dr. N. Venkata Reddy, Mr. M. Narayana Reddy, Mr. L. V. Subba Reddy, and Mr. Ravindra Reddy, and their families. VLL has two other subsidiaries besides AOL; Virchow Healthcare Private Limited (VHPL) and Virchow Drugs Limited (VDL, rated at [ICRA]A-(Stable)/[ICRA]A2+). While VDL specialises in the manufacturing of intermediates and APIs sold in the domestic and export markets, VHPL manufactures and markets formulated products for export markets.

VLL, along with AOL, is a leading producer of SMX (an API for antibiotic). AOL is involved in the manufacturing of CIS Lactum (an advanced intermediate used in manufacturing of diltiazem (cardiovascular)), TMP (used as a synergic combination with SMX to make co-trimoxazole) and sildenafil citrate (pulmonary arterial hypertension), besides sulfamethoxazole.

Key financial indicators (audited)

| | VLL | | AOL | | Consolidated* | |
|--|--------|--------|--------|--------|---------------|--------|
| | FY2019 | FY2020 | FY2019 | FY2020 | FY2019 | FY2020 |
| Operating Income (Rs. crore) | 371.9 | 311.3 | 627.1 | 559.4 | 935.1 | 804.2 |
| PAT (Rs. crore) | 31.0 | 31.1 | 66.5 | 90.4 | 97.5 | 121.6 |
| OPBDIT/OI (%) | 11.8% | 12.4% | 15.5% | 20.3% | 15.1% | 18.9% |
| PAT/OI (%) | 8.3% | 10.0% | 10.6% | 16.2% | 10.4% | 15.1% |
| Total Outside Liabilities/Tangible Net Worth (times) | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| Total Debt/OPBDIT (times) | 0.5 | 0.4 | 0.3 | 0.3 | 0.3 | 0.3 |
| Interest Coverage (times) | 73.3 | 87.2 | 114.7 | 235.6 | 97.5 | 164.6 |

PAT: Profit after Tax; OPBDIT: Operating Profit before Depreciation, Interest, Taxes and Amortisation; *Consolidated financials adjusted for related party transactions

Status of non-cooperation with previous CRA

CRISIL Ltd. had suspended CRISIL A+/Stable and CRISIL A1+ ratings assigned to the bank facilities of Andhra Organics Limited on July 13, 2012. The suspension of ratings was on account of non-cooperation by the company.

Any other information: None

Rating history for past three years

| | Instrument | Current Rating (FY2022) | | | | Chronology of Rating History for the past 3 years | | | |
|---|-----------------------------------|-------------------------|--------------------------|--------------------------------|-------------------------------|---|-------------------------|-------------------------|-------------------|
| | | Type | Amount Rated (Rs. crore) | Amount Outstanding (Rs. crore) | Date & Rating in Apr 22, 2021 | Date & Rating in FY2021 | Date & Rating in FY2020 | Date & Rating in FY2019 | |
| | | | | | | | Oct 15, 2018 | Jul 12, 2018 | |
| 1 | Working capital facility | Long-term | 7.50 | -- | [ICRA]A+ (Stable) | - | [ICRA]A+ (Stable) | [ICRA]A+ (Stable) | [ICRA]A+ (Stable) |
| 2 | Letter of credit & bank guarantee | Short term | 1.50 | -- | [ICRA]A1+ | - | [ICRA]A1+ | [ICRA]A1+ | [ICRA]A1+ |

Amount in Rs. crore

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 facility | NA | NA | NA | 7.50 | [ICRA]A+ (Stable) |
| NA | Non-fund based facility | NA | NA | NA | 1.50 | [ICRA]A1+ |

Source: Company

Annexure-2: List of entities considered for consolidated analysis

| Company Name | Ownership | Consolidation Approach |
|------------------------------|-----------|------------------------|
| Virchow Laboratories Limited | 100.00% | Full Consolidation |

Source: Company

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