April 28, 2023

Natco Pharma Limited: Ratings reaffirmed

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Long-term Fund-based Working Capital	866.50	866.50	[ICRA]AA (Stable); reaffirmed
Long Term/ Short Term – Fund based / Non-fund Based Working Capital	155.00	155.00	[ICRA]AA (Stable)/[ICRA]A1+; reaffirmed
Short-term Non-Fund Based Working Capital	85.00	85.00	[ICRA]A1+; reaffirmed
Long-term/ Short-term Unallocated	43.50	43.50	[ICRA]AA(Stable)/[ICRA]A1+; reaffirmed
Commercial Paper	400.00	400.00	[ICRA]A1+; reaffirmed
Total	**1,550.00**	**1,550.00**	

**Instrument details are provided in Annexure-I*

Rationale

The ratings reaffirmation considers Natco Pharma Limited's (Natco/the company) healthy abbreviated new drug application (ANDA) portfolio in the complex generics space in the US market complemented by its strong research and development (R&D) capabilities. Further, notable market position in the domestic oncology formulations segment and robust financial profile also support the ratings. The company witnessed YoY revenue de-growth of 5.2% in FY2022 given the high base of FY2021, which included Covid-led supplies. Further, adverse impact of competition-induced pricing pressures in the domestic and US markets also impacted revenues in FY2022 despite Revlimid contribution in Q4 FY2022. That said, Natco witnessed robust YoY revenue growth of 37.4% in 9m FY2023 mainly backed by substantial profit share contribution from Revlimid and improved performance of its Canadian and Brazilian subsidiaries. The operating profit margins (OPM) contracted to 13.5% in FY2022 from 29.5% in FY2021, primarily due to write-down of large Covid-19 inventory and provisioning of credit losses amounting to Rs. 282 crore. Adjusting for the write offs, the OPM remained healthy at 28.0% in FY2022. During 9M FY2023, OPM expanded to 33.0% from 20.9% in 9M FY2022 primarily supported by improved scale of operations in addition to profit share from Revlimid. The margins are likely to expand further with the accrual of incremental Revlimid profit share in Q4 FY2023. Going forward, Natco's revenues are expected to remain rangebound over the near term, supported by the contribution from the product launches in the last two years. Despite expected improvement in market share for Revlimid, the operating margins are likely to moderate over the near term due to pricing pressures in the domestic as well as US markets. That said, OPM is expected to remain healthy. The ratings also continue to factor in the extensive experience of the promoters, its successful track record of regulatory inspections along with the backward-integrated nature of its operations with strong capabilities in API.

The ratings consider the high product concentration with a few molecules driving the company's US formulations business and its top five products accounting for ~45% of its domestic formulations business. The ratings also consider the intense competition in the domestic formulation business leading to material price erosion. Natco's working capital intensity remains high with a growing product portfolio and increasing focus on international markets. Further, the company has stocked inventories more than the normal holding levels to mitigate supply chain challenges for few of the products with high lead time. Going forward, while chlorantraniliprole (CTPR) inventory is expected to be liquidated largely during Q2 FY2024, gradual reduction is expected in the other inventories only with easing of supply chain challenges.

Additionally, increasing scrutiny by the US FDA[1], compliance costs and risks associated with the same on the company's operations along with its exposure to potential adverse outcome on any product litigations will be key rating sensitivities, going forward. In the US market, the company has tie-ups with front-end players for a profit share contribution to launch its complex generics or Para IV filing. Further, it has also acquired Dash Pharmaceuticals LLC (Dash) in January 2022 to create its own front-end presence. Thereby, the company remains exposed to potential litigation risks. ICRA will continue to monitor the impact of any adverse outcome of such litigations on the credit profile of the company.

The company has been exploring new product acquisitions via inorganic expansion opportunities Any significant debt-funded acquisition impacting its credit metrics, remains an event risk and would be evaluated on a case-by-case basis.

ICRA also notes that the company approved the proposal for buyback of 30 lakh equity shares through the "open market route" during March 2023 for a consideration not exceeding Rs 210 crore. The buyback is expected to be completed by September 2023 with an expected total cash outflow (including the buyback taxes) of ~Rs 250 crore.

The Stable outlook on the rating reflects ICRA's opinion that Natco will continue benefiting from its strong market position, strong track record of R&D capabilities and healthy financial profile.

Key rating drivers and their description

Credit strengths

Healthy ANDA portfolio in the complex generics space continue to support business prospects – The company has predominantly focused on complex products with high barriers to entry in the US. The volume-limited launch of gRevlimid in the US during March 2022 (with the sale volume expected to increase steadily every year) supported substantial ramp up of Natco's revenues and profit margins in FY2023. In the past, the launch of the complex generic version of Copaxone (40 mg) in October 2017 and the steady gain in market share (more than 30% share) by its marketing partner, Mylan supported the company's revenues and margins in the US market. Also, the company has witnessed improvement in the performance of its subsidiaries in Canada and Brazil during 9m FY2023 (over 150% revenue growth with operating profits) backed by incremental contribution from the new product launches in FY2022. Natco's strategy of leveraging its limited competition and complex molecule portfolio in geographies like Brazil, Canada, Australia, and other south-east Asian countries is expected to support its revenues, going forward. Further, Natco has a pipeline of 19 Para IV filings (11 are approved) as on December 31, 2022, with a few significant launches (few of which are subject to approval/litigation) in the medium term.

Strong R&D capabilities and successful track record of regulatory inspections – Natco continues to invest a high single-digit percentage of its revenues in R&D every year, except for FY2022 where it incurred 11.7% of revenues as R&D expenses, thereby supporting its strong capabilities to develop limited competition and difficult-to-develop molecules for the regulated markets. Strong manufacturing capabilities in addition to backward integration into API manufacturing continue to support the company's revenue. Further, the company has a successful track record of regulatory inspections in its manufacturing facilities with a few form-483 observations in the past.

Notable market position in domestic oncology segment; expected improvement in agrochemicals segment – As an early entrant with regular product introductions and competitive pricing, Natco has managed to establish a strong presence in the domestic formulations market with a significant market share in the domestic oncology segment. The company continues to be one of the leading players in the domestic oncology segment, despite facing intense competition that leads to pricing pressures. The company is also increasing its sales force coverage in the cardiology and diabetology division (C&D), which is expected to diversify its revenue profile in the domestic formulations business. Further, while the company has been witnessing losses in the agrochemical segment till 9m FY2023, the profitability is expected to improve in the near term backed by increased scale of operations supported by the launch of CTPR in October 2022.

[1] US FDA - U.S. Food and Drug Administration

Financial profile characterised by robust debt metrics and strong liquidity position – Natco's financial risk profile is characterised by robust debt protection metrics on the back of low debt availed by the company (NIL gearing and TD/OPBDITA of 0.1x as on September 30, 2022). ICRA notes that write down of large Covid-19 related inventory and provisioning of expected credit losses led to contraction in OPM in FY2022. Against this backdrop, while the company witnessed negative net debt position, TD/OPBDITA was at 1.6x as on March 31, 2022. However, with improvement in margins in 9M FY2023, TD/OPBDITA improved to 0.1x as on September 30, 2022. Further, the company is expected to have continued to maintain its negative net debt position with estimated strong cash and cash equivalents of ~Rs 1,000 crore at consolidated level as on March 31, 2023. The revenue contribution from the product launches in the US and other markets (gRevlimid gAfinitor, gZortress in the US and gRevlimid, gPomalyst in Canada) is expected to support the margins, going forward.

Credit challenges

High product concentration – The company derives majority of its US formulation revenues from gRevlimid, gCopaxone, gFosrenol, gTykerb, gTamiflu, gDoxil, gAfinitor and gZortress. Going forward, the product concentration risk is expected to remain high with the substantial revenue contribution expected from gRevlimid in the US in the near term. The top five products accounted for ~45% of the company's domestic formulations business. While the concentration has reduced over the years, the same continues to remain high. Going forward, it is expected to ease gradually with new launches in the oncology / C&D segments.

High working capital intensity – As Natco expands its product portfolio, it needs to maintain a certain level of inventory to optimise its production schedule and minimise switchover costs at plants which manufacture multiple APIs or formulations. The company has stocked large inventory for CTPR to the tune of ~Rs 110 crore and carries relatively higher inventory to mitigate supply chain challenges for few of the products with high lead time. This led to increase in inventory days to 265 days as on September 30, 2022, from the average level of ~190 days in the past. While CTPR inventory is expected to be liquidated largely during Q2 FY2024, gradual reduction is expected in the other inventories only with easing of supply chain challenges. That said, with a growing product portfolio (which requires higher level of inventory to be maintained) and increasing focus on markets like Brazil, Canada, Southeast Asia, and China (which generally have a higher receivables period than the domestic segment), Natco's working capital requirements will remain high, going forward.

Increasing competition in key markets – High competitive intensity leading to pricing pressures along with relatively high base of Covid-led supplies during Q1 FY2022 led to contraction in Natco's revenues from the domestic market in 9M FY2023. Further, three generic players have entered the gRevlimid market (current market size of ~$8.5-9 billion) in the US, which would lead to further price erosion, thereby impacting the overall market size of the drug. New entrants, pricing pressure and intense competition in the company's Para IV portfolio will continue to have a bearing on its revenues and margins going forward.

Exposure to regulatory risks and litigations – Natco is exposed to increasing regulatory scrutiny, compliance costs and risks associated with the same. However, ICRA also notes that there has been no significant impact on the company in the past due to regulatory factors and it has launched complex generics with high entry barriers in the US market. Further, the company has ~50% of its domestic formulation products covered under NLEM, which though has benefitted from the 10.7% increase in prices allowed for FY2023, remains exposed to future price control measures or addition of more products in the list of NLEM drugs. Also, in view of the risks associated with the product litigations, ICRA will continue to monitor the impact of any adverse outcome of such litigations on the credit profile of the company.

Environmental and Social Risks

Natco does not face any major physical climate risk. However, it remains exposed to tightening environmental regulations with regard to breach of the waste and pollution norms, which can lead to an increase in operating costs and new capacity installation costs. This can also require capital investments to upgrade its effluent treatment infrastructure to reduce the carbon footprint and waste generation.

The company has been undertaking initiatives that are expected to have environmental benefits and improve the organisation's sustainability. This includes utilisation of renewable energy, which contributes ~25% to its energy consumption, thereby reducing carbon emissions. It practices water conservation by increasing its usage of recycled water. It also ensures that the waste generated during the manufacturing process is appropriately disposed.

The industry faces social risks related to product safety and the associated litigation risks, access to qualified personnel for R&D and process engineering, and maintenance of high manufacturing compliance standards. Further, government intervention related to price caps/control also remains a social risk faced by entities in the pharmaceutical industry.

Liquidity position: Strong

The company's liquidity position is strong, characterised by consolidated cash and cash equivalents of ~Rs 1,000 crore as on March 31, 2023. In addition, the company had undrawn working capital limits of Rs. 490 crore as on February 28, 2023. Further, the company is expected to generate positive fund flow from operations supported by healthy cash accruals over the near term. There are no long-term debt obligations as on date. Natco is expected to incur capex of ~Rs. 250-300 crore per annum on maintenance capex and expansion, going forward. While the buyback-related outflow is expected to be ~Rs 250 crore in FY2024, ICRA expects Natco to meet its capital commitments through existing cash reserves and internal cash accruals.

Rating sensitivities

Positive factors – A significant improvement in the company's product diversification, given its focus on a few critical molecules, and a scale-up in its revenues with continued robust debt protection metrics and liquidity would be a positive trigger.

Negative factors – Pressure on Natco's ratings could arise if there is a deterioration in the margins or if debt-funded capex or acquisitions or regulatory measures lead to the weakening of the company's credit profile with Net Debt/OPBDITA>1.25x on a sustained basis.

Analytical approach

Analytical Approach	Comments
Applicable rating methodologies	Corporate Credit Rating Methodology Rating Methodology for entities in pharmaceutical industry Rating Approach - Consolidation
Parent/Group support	Not Applicable
Consolidation/Standalone	For arriving at the ratings, ICRA has considered the consolidated financial statement of Natco.

About the company

Natco is a medium-sized pharmaceutical company, which develops, manufactures and markets formulations and APIs. Founded in 1981, Natco has emerged as an established pharmaceutical company with a presence in formulations and APIs in both domestic and export markets. The company owns eight manufacturing facilities and the Natco Research Centre in Hyderabad. Its formulations units in Kothur (Telangana) and Visakhapatnam (Andhra Pradesh) and API facilities in Chennai and Mekaguda (Telangana)are approved by the authorities of regulated markets, including the US FDA. The company had also set up an agrochemicals facility in Nellore (Andhra Pradesh) to diversify its portfolio. As an early entrant with strong R&D capabilities, Natco has established itself as a leading player in the oncology segment in India. In addition, it generates a sizeable proportion of its formulations business from exports. It enjoys a presence in the generics business in the regulated markets of North America and Europe and branded generics in the rest of the world (RoW). As on March 31, 2023, 48.86% of the company's shareholding was held by the promoter group, with the rest held by various institutions and the public.

Key financial indicators (audited)

Natco Consolidated	FY2021	FY2022	9M FY2023
Operating income	2,052.1	1,944.8	1,809.2
PAT	442.4	170.0	439.5
OPBDIT/OI	29.5%	13.5%	33.0%
PAT/OI	21.6%	8.7%	24.3%
Total outside liabilities/Tangible net worth (times)	0.2	0.2	NA
Total debt/OPBDIT (times)	0.5	1.6	NA
Interest coverage (times)	45.6	14.9	NA

PAT: Profit after tax; OPBDIT: Operating profit before depreciation, interest, taxes and amortisation; Amount in Rs. crore; All amounts as per ICRA calculations

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 as of Mar 31, 2023 (Rs. crore)	Date & rating in FY2024	Date & rating in FY2023	Date & rating in FY2022	Date & rating in FY2021
					Apr 28, 2023	Apr 28, 2022	April 29, 2021	--
1	Fund Based Limits	Long Term	866.50	--	[ICRA]AA (Stable)	[ICRA]AA (Stable)	[ICRA]AA (Stable)	--
2	Fund Based/ Non-fund Based Limits	Long Term /Short Term	155.00	--	[ICRA]AA (Stable)/ [ICRA]A1+	[ICRA]AA (Stable)/ [ICRA]A1+	[ICRA]AA (Stable)/ [ICRA]A1+	--
3	Non-fund Based Limits	Short Term	85.00	--	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	--
4	Unallocated Limits	Long Term /Short Term	43.50	--	[ICRA]AA (Stable) / [ICRA]A1+	[ICRA]AA (Stable) / [ICRA]A1+	[ICRA]AA (Stable) / [ICRA]A1+	--
5	Commercial Paper	Short Term	400.00	--	[ICRA]A1+	[ICRA]A1+	[ICRA]A1+	--

Complexity level of the rated instruments

Instrument	Complexity Indicator
Fund Based Limits	Simple
Fund Based/ Non-fund Based Limits	Simple
Non-fund Based Limits	Very Simple
Unallocated Limits	Not Applicable
Commercial Paper	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	Long-term Fund-based Working Capital	NA	NA	NA	866.50	[ICRA]AA(Stable)
NA	Long Term/Short Term – Fund-based/Non-fund Based Working Capital	NA	NA	NA	155.00	[ICRA]AA(Stable)/[ICRA]A1+
NA	Short-term Non-Fund Based Working Capital	NA	NA	NA	85.00	[ICRA]A1+
NA	Long-term/ Short-term Unallocated	NA	NA	NA	43.50	[ICRA]AA(Stable)/[ICRA]A1+
Not placed	Commercial Paper	NA	NA	NA	400.00	[ICRA]A1+

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	Natco Ownership	Consolidation Approach
NATCO Pharma, Inc.	100.00%	Full Consolidation
Time Cap Overseas Limited	100.00%	Full Consolidation
NATCO Farmo Do Brazil Ltda	100.00%	Full Consolidation
NATCO Pharma (Canada), Inc.	99.04%	Full Consolidation
NATCO Pharma Asia Pte. Ltd.	100.00%	Full Consolidation
NATCO Pharma Australia PTY Ltd.	100.00%	Full Consolidation
NATCO Lifesciences Philippines Inc	100.00%	Full Consolidation
Dash Pharmaceuticals LLC	100.00%	Full Consolidation

Source: Natco annual report FY2022
Note: ICRA has taken a consolidated view of the parent (Natco), its subsidiaries and associates while assigning the ratings.

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About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

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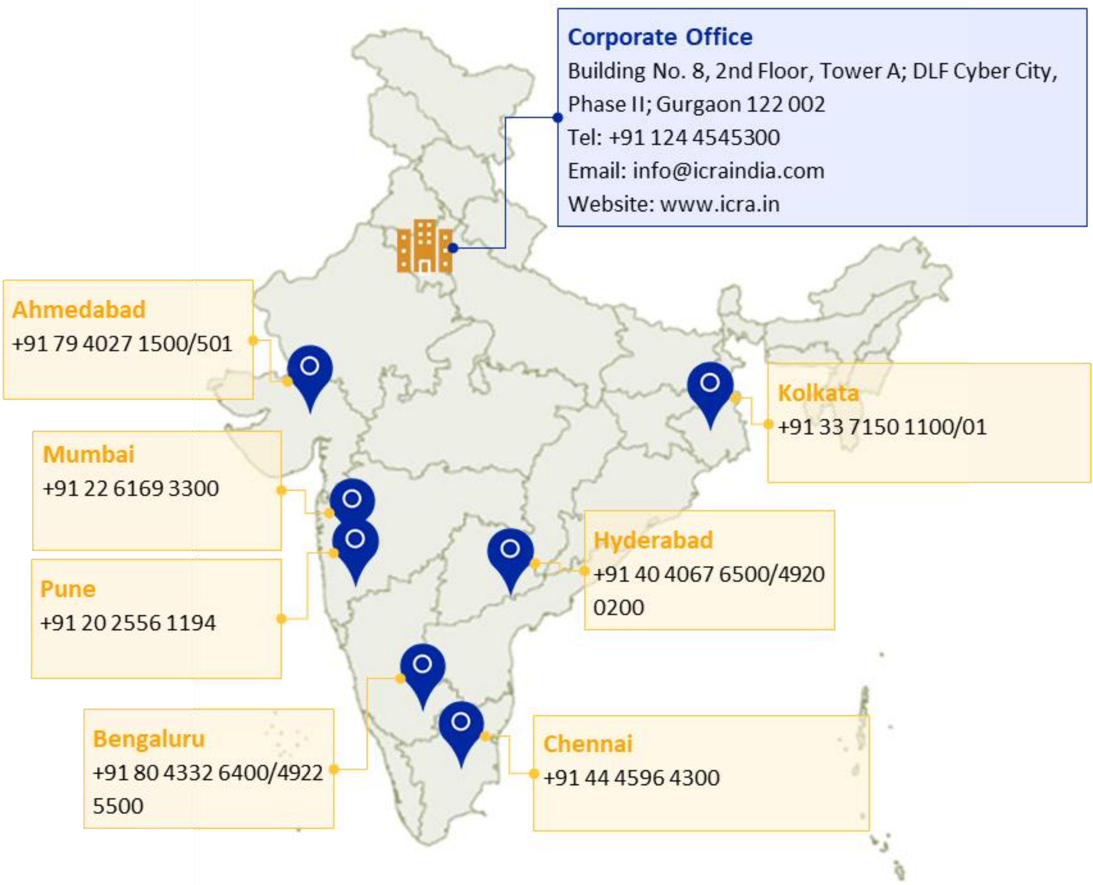

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