January 03, 2024

Covalent Laboratories Private Limited: Ratings reaffirmed; outlook revised to Positive from Stable

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Long-term – fund-based – term loans	43.74	30.00	[ICRA]A- Reaffirmed; Outlook revised to Positive from Stable
Long-term – fund-based – working capital facilities	210.00	210.00	[ICRA]A- Reaffirmed; Outlook revised to Positive from Stable
Short-term – non-fund-based limits	83.00	83.00	[ICRA]A2+; Reaffirmed
Long-term/Short-term – Unallocated limits	-	13.74	[ICRA]A-/[ICRA]A2+ Reaffirmed; Outlook revised to Positive from Stable
Total	**336.74**	**336.74**	

**Instrument details are provided in Annexure-I*

Rationale

The revision in the outlook of Covalent Laboratories Private Limited (CLPL) reflects ICRA's opinion that CLPL is likely to report healthy revenue growth and accrual generation over the near to medium term. This shall be supported by its established market position as one of the leading manufacturers of its key molecules, such as Cefixime, Axetil, Proxetil and Cefdinir in India, and its established relationships with major domestic formulations manufacturing companies. CLPL reported healthy growth over the past two years, with revenue of Rs. 2,217.0 crore in FY2023 (+23.0% YoY growth) and Rs. 1,399.8 crore in H1 FY2024 (+50.5% YoY growth). The growth was driven by a combination of increase in realisations and volumes sold across some of its key molecules. Steady accrual generation, coupled with a comfortable capital structure, is expected to continue to result in a healthy financial profile, marked by comfortable debt protection metrics and adequate liquidity position. The ratings also factor in CLPL's established operational track record in the manufacturing and sale of the cephalosporins class of antibiotic molecules. Moreover, its promoters have an extensive experience of more than two decades in the industry. Further, the company also benefits from sourcing a key raw material at an extended credit period from its Group company, Virchow Petrochemicals Private Limited (VPPL), 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 80-85% of its total revenues. Moreover, CLPL's profitability remains vulnerable to raw material costs and limited pricing flexibility owing to dependence on mature molecules. This was also demonstrated by the decline in operating margin in FY2023 to 3.6% from 5.4% in FY2022. However, its operating margin improved to 9.9% in H1 FY2024[1] on account of increased backward integration through manufacturing of some intermediates, lower raw material costs and benefits of economies of scale. However, sustenance of operating margin shall remain contingent upon the ability of the company to navigate through the volatility in raw material prices.

Further, CLPL's profitability remains vulnerable to forex fluctuations as it imports around 35-40% 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 profitability and gradually enable CLPL to become a

[1] *As per provisional financials*

net exporter. The operations of the company also remain exposed to regulatory risks arising out of the scrutiny of various regulatory agencies.

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, which has been present in the active pharmaceutical ingredient (API) industry for over four decades. The Group consists of six independent API, one bio-pharmaceutical and two drug intermediate manufacturing companies. The key promoters/directors of CLPL have an established experience of more than two decades in manufacturing APIs and intermediates of cephalosporins. Moreover, CLPL purchases around 35-40% of its raw material from Group company, VPPL, which provides it an extended credit period of 100-120 days to support its credit cycle.

High market share for key molecules and established presence in domestic market, supported by reputed customer base – CLPL is an established company in the cephalosporin API space with a reputable track record and long-term relationship with large domestic formulations manufacturers with a recurring order inflow. Its top five customers generated 18.3% of its total FY2023 revenues, indicating low customer concentration. The company has a healthy market share in the domestic market for its key molecules, i.e., Cefixime, Proxetil, Axetil and Cefdinir.

Diversified revenue stream due to presence in both domestic and export markets – While its presence in export markets is limited, exports witnessed 45.6% YoY growth in FY2023 to ~Rs. 580 crore and 14.4% YoY in H1 FY2023 to ~Rs. 331 crore. CLPL sells to unregulated, semi-regulated as well as regulated markets; although sales to regulated markets are primarily via Indian formulation companies. While the company continues to maintain a strong market share for its key molecules in the domestic market, the management continues to actively work towards increasing the share of exports in its total revenue basket.

Healthy financial profile – CLPL continues to maintain a robust financial profile despite some moderation in operating margins over FY2023. Moreover, it witnessed an improvement in operating margins in H1 FY2024 leading to further improvement in its financial profile, also supported by reduction in its total debt on account of scheduled repayment of long-term debt and reduction in utilisation of working capital limits. The gearing, interest coverage and TOL/TNW were recorded at 0.3 time, 6.4 times and 1.7 times, respectively, in FY2023 and 0.2 time, 25.9 times and 1.6 times, respectively, in H1 FY2024. Further, its debt levels are expected to remain range-bound on account of scheduled repayment of long-term debt and no requirement of debt-funded capex over the near to medium term, resulting in comfortable coverage metrics.

Credit challenges

High product concentration on cephalosporins; relatively limited pricing flexibility owing to dependence on mature molecules – Three key molecules, i.e., Cefixime, Axetil and Proxetil, continue to generate up to 85% of CLPL's overall revenue. In FY2023, these molecules contributed ~84% to CLPL's total revenue. Cefexime continues to remain its major revenue earner, generating 50% of its FY2023 revenues, followed by Axetil (21%) and Proxetil (12%). Considering these are mature molecules whose patents expired more than a decade ago, their market continues to remain competitive with low pricing flexibility. However, CLPL has been able to maintain a strong market share across these molecules on account of its established operational track record. Furthermore, CLPL is working towards developing a process for manufacturing intermediates of its key molecules to reduce its dependence on imports and improve its profitability and has already implemented a few such plans. ICRA also notes that the manufacturing operations of the company are carried out from a single plant location, which exposes it to some concentration risk. However, the plant has six operational blocks, while another block is currently under development, mitigating the risk to a certain extent.

Profitability indicators vulnerable to movement in raw material costs and forex fluctuations – Owing to the limited pricing flexibility and volatility in raw material prices, CLPL continues to witness volatility in its profitability indicators. Any rise in raw material prices is partially passed on to its customers with a lag of 3-6 months. Rise in raw material and overhead costs over FY2023 resulted in reduction of CLPL's operating margins to 3.6% in FY2023 from 5.4% in FY2022; however, the operating margin improved to 9.9% in H1 FY2024 on account of lower raw material cost, economies of scale and stabilisation of in-house manufacturing of intermediates of some molecules. The sustenance of these margins shall be contingent on CLPL's ability to manage the volatility in raw material prices. Further, its profitability is also exposed to forex fluctuations as ~25% of its revenue comes from exports, while it also imports up to 35-40% of its raw material requirements.

Exposure to regulatory risks – As is the case with its peers, CLPL's operations remain exposed to regulatory risks of scrutiny by regulatory agencies like the US FDA[2], EU GMP[3] and WHO GMP[4], 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 and unencumbered cash and bank balance of Rs. 34.3 crore as on September 30, 2023. The liquidity is additionally supported by its unutilised bank facilities of ~Rs. 170 crore as on September 30, 2023. CLPL has a capex commitment of ~Rs. 50 crore in FY2024 and ~Rs. 20-25 crore over FY2025 and FY2026. It also has moderate repayment obligations of ~Rs. 7–14 crore p.a. from FY2024 to FY2026. However, its internal accrual generation is expected to be sufficient to service its capex and repayment obligations.

Rating sensitivities

Positive factors – CLPL's ratings may be upgraded if there is a healthy growth in revenues and accruals, leading to strengthening of its financial profile. Specific credit metrics that could lead to a rating upgrade include TOL/TNW lesser than 1.2 times on a sustained basis.

Negative factors – Negative pressure on CLPL's ratings 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 DSCR less than 1.8 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

CLPL is a part of the Hyderabad-based Virchow Group, formed in 2002. It was incorporated by Mr. Madireddy Narayana Reddy and his associates, specialising in the manufacturing of APIs and intermediates for cephalosporins in the therapeutic segment of beta-lactamase antibiotic. The key products of CLPL include APIs for four cephalosporin drugs—Cefixime, Axetil, Proxetil and Cefdinir. It is the largest manufacturer of Cefixime, Axetil and Cefdinir in India as per the management. CLPL has a single

[2] *United States Food and Drugs Administration*

[3] *European Union – Good Manufacturing Practices*

[4] *World Health organisation – Good Manufacturing Practices*

manufacturing facility at Medak district in Hyderabad, with an installed capacity of 2,116 metric tonnes per annum (MTPA). The facility is US FDA, EU GMP, WHO GMP and ISO 14001-2004 certified.

Key financial indicators (audited)

CLPL - Standalone	FY2022	FY2023
Operating income	1802.0	2217.0
PAT	52.5	35.0
OPBDIT/OI	5.4%	3.6%
PAT/OI	2.9%	1.6%
Total outside liabilities/Tangible net worth (times)	1.4	1.7
Total debt/OPBDIT (times)	1.6	1.6
Interest coverage (times)	11.6	6.4

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 as of Sept 30, 2023 (Rs. crore)	Date & rating in FY2024	Date & rating in FY2023	Date & rating in FY2022	Date & rating in FY2021
					Jan 03, 2024	Nov 17, 2022	Oct 06, 2021	Oct 12, 2020
1	**Fund Based – Term Loans**	Long term	30.00	28.13	**[ICRA]A- (Positive)**	**[ICRA]A- (Stable)**	**[ICRA]A- (Stable)**	**[ICRA]A- (Stable)**
2	**Fund Based – Working Capital Facilities**	Long term	210.00	-	**[ICRA]A- (Positive)**	**[ICRA]A- (Stable)**	**[ICRA]A- (Stable)**	**[ICRA]A- (Stable)**
3	**Non-Fund Based Limits**	Short term	83.00	-	**[ICRA]A2+**	**[ICRA]A2+**	**[ICRA]A2+**	**[ICRA]A2+**
4	**Unallocated Limits**	Long term and short term	13.74	-	**[ICRA]A- (Positive)/ [ICRA]A2+**	-	-	-
5	**Fund Based Limits**	Short term	-	-	-	-	**[ICRA]A2+**	**[ICRA]A2+**
6	**Unallocated Limits**	Long term	-	-	-	-	**[ICRA]A- (Stable)**	**[ICRA]A- (Stable)**

Complexity level of the rated instruments

Instrument	Complexity Indicator
Long Term – Fund Based – Term Loans	Simple
Long Term – Fund Based – Working Capital Facilities	Simple
Short Term – Non-Fund Based Limits	Very Simple
Long Term/Short Term – Unallocated Limits	Not Applicable

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 Loans	June 2022	NA	June 2027	30.00	[ICRA]A- (Positive)
NA	Working Capital Facilities	NA	NA	NA	210.00	[ICRA]A- (Positive)
NA	Non-Fund Based Limits	NA	NA	NA	83.00	[ICRA]A2+
NA	Unallocated Limits	NA	NA	NA	13.74	[ICRA]A- (Positive)/[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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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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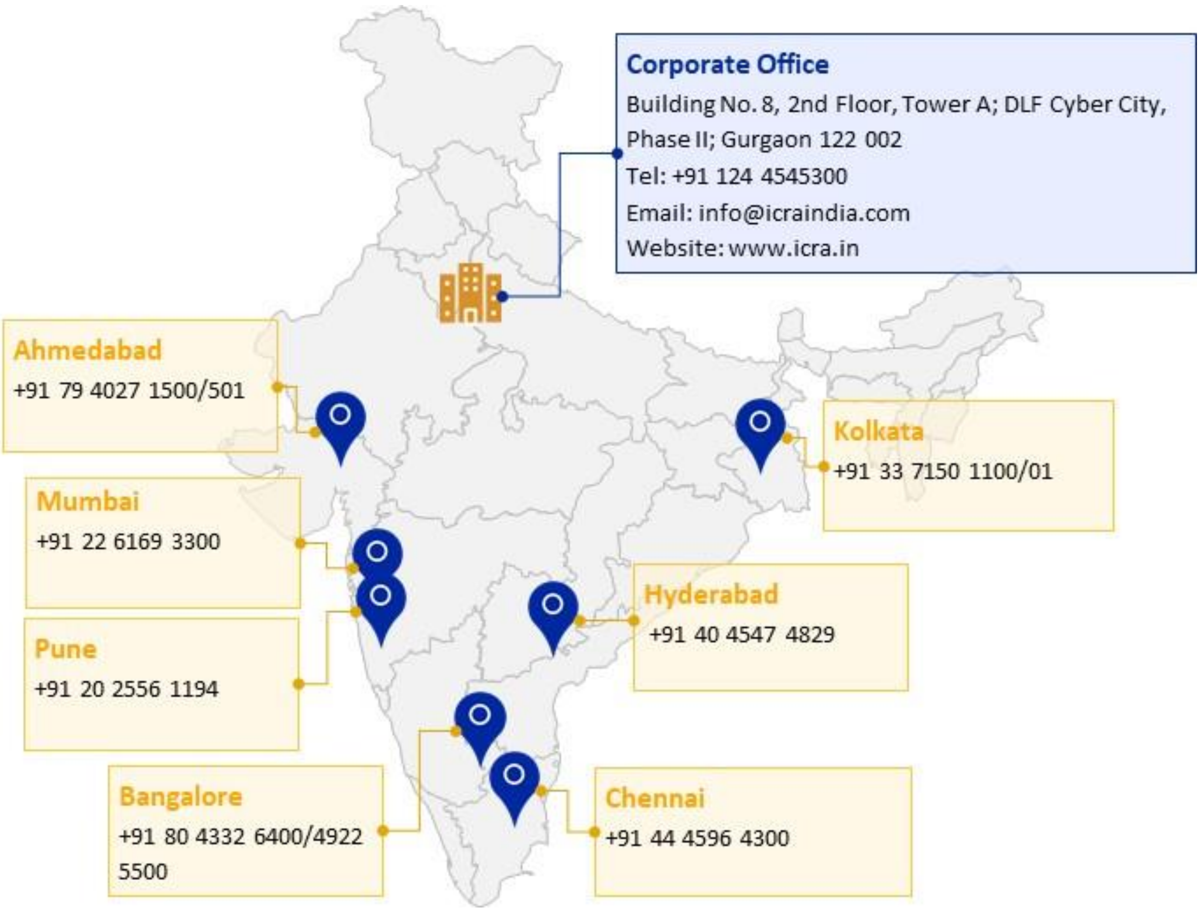

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