October 23, 2024

Covalent Laboratories Private Limited: Long term rating upgraded to [ICRA]A; short term rating reaffirmed; outlook revised to Stable from Positive

Summary of rating action

Instrument*	Previous Rated Amount (Rs. crore)	Current Rated Amount (Rs. crore)	Rating Action
Long-term – fund-based – term loans	30.00	30.00	[ICRA]A; upgraded from [ICRA]A-; outlook revised to Stable from Positive
Long-term – fund-based – working capital facilities	210.00	210.00	[ICRA]A; upgraded from [ICRA]A-; outlook revised to Stable from Positive
Short-term – non-fund-based limits	83.00	83.00	[ICRA]A2+; reaffirmed
Unallocated limits	13.74	-	-
Total	**336.74**	**323.00**	

**Instrument details are provided in Annexure-I*

Rationale

The upgrade in the long-term rating of Covalent Laboratories Private Limited (CLPL) factors in the strengthening of its financial risk profile in FY2024 and the expectation of sustenance of the same. In FY2024, CLPL reported revenue of Rs. 2,916.1 crore with a 31.5% growth on a YoY basis, supported by an increase in volumes sold, along with some improvement in realisations. Moreover, the stabilisation of raw material prices and higher backward integration through the manufacturing of intermediates resulted in an improvement in its operating margins to 10.2% in FY2024 from 3.6% in FY2023.

CLPL's healthy cash accruals have reduced the company's reliance on external debt, leading to an improvement in its debt protection metrics. The company also witnessed significant growth in its exports as direct exports contributed ~28% and total sales to export markets (including third party and deemed exports) contributed ~36% to its FY2024 revenue. ICRA expects the company to continue reporting healthy accrual generation while maintaining a comfortable capital structure and strong debt protection metrics over the near to medium term.

The ratings also continue to factor in CLPL's established operational track record in the manufacturing and sale of the cephalosporins class of antibiotic molecules, with its promoters having extensive experience of over two decades in the active pharmaceutical ingredients (API) industry. This has helped CLPL establish its market position as one of the leading manufacturers of molecules like Cefixime, Axetil, Proxetil and Cefdinir in India. Leveraging the same, the company has also developed strong relationships with major domestic formulation manufacturing companies.

The ratings, however, continue to remain constrained by CLPL's high product concentration risk, with its four key molecules generating more than 90-95% of its total revenues. Moreover, CLPL's profitability remains vulnerable to raw material costs and limited pricing flexibility owing to its dependence on mature molecules. The volatility in the manufacturing process of penicillin G over the last few years resulted in a significant fluctuation in CLPL's raw material prices and realisations. This was also demonstrated by the decline in its OPM in FY2023 to 3.6% from 5.4% in FY2022. Subsequently, OPM improved to 10.5% in FY2024 on account of improved realisations, lower raw material costs and increased backward integration through in-house manufacturing of some intermediates. However, the sustenance of the operating margin shall remain contingent upon the company's ability to navigate through the volatility in raw material prices.

Further, CLPL's profitability remains vulnerable to forex fluctuations as it imports a significant proportion of its total raw materials. 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 while reducing its imports. The company's operations also remain exposed to regulatory risks arising out of the scrutiny from various regulatory agencies.

The Stable outlook reflects ICRA's opinion that CLPL will continue to benefit from its established position in the API industry and adequate liquidity position, which will continue to support its credit profile.

Key rating drivers and their description

Credit strengths

Established operational track record and extensive experience of promoters in the industry – CLPL has an established track record of more than two decades in the manufacturing and sales of APIs and intermediates for cephalosporins in the therapeutic segment of beta-lactamase antibiotics. The key promoters/directors of CLPL also have extensive experience of more than 20 years in the manufacturing of APIs and intermediates of cephalosporins. Moreover, CLPL is a part of the Virchow Group, which also has over four decades of experience in the API industry. CLPL purchases up to 40-50% of its raw material from its group company, Virchow Petrochemicals Private Limited.

High market share for key molecules and established presence in domestic market, supported by reputed customer base – Over the ears, CLPL has established itself as a leading manufacturer of cephalosporin APIs like Cefixime, Proxetil, Axetil and Cefdinir in India. It has a reputable track record and established relationships with large domestic formulation manufacturers with a recurring order inflow. Its top five customers generated ~17% of its total FY2024 revenues, indicating low customer concentration.

Diversified revenue stream due to presence in both domestic and export markets – CLPL's presence in export markets has been increasing gradually and its exports grew by 42% YoY to Rs. 824 crore in FY2024, contributing 28.4% to its overall FY2024 revenue. CLPL's total sale to export markets (including third party and deemed exports) were Rs. 1,049.9 crore with a YoY growth of 47.5% generating 36% of its FY2024 revenues. CLPL primarily exports to unregulated/ semi-regulated markets, however, it also sells in regulated markets directly and through Indian formulation companies.

Healthy financial profile – The steady growth in the company's revenues and a significant improvement in OPM over FY2024, leading to healthy cash accruals, reduced CLPL's dependence on external borrowings, which supported the improvement of its financial risk profile. Its gearing and total debt/OPBDITA improved to 0.1 times and 0.3 times, respectively, as on March 31, 2024 from 0.3 times and 1.6 times, respectively, as on March 31, 2023. The interest coverage ratio also improved to 42.0 times in FY2024 from 6.4 times in FY2023. The expected sustenance of healthy performance, moderate debt repayment obligations and the ability to fund its capex plans largely through internal accruals are projected to support CLPL's financial risk profile over the near-to-medium term.

Credit challenges

High product concentration on cephalosporins; relatively limited pricing flexibility owing to dependence on mature molecules – CLPL's top four molecules have contributed 90-95% to its overall revenues over the years. In FY2024, these molecules contributed ~92% to CLPL's revenue. Within the top four products, Cefexime (45-55% of overall revenue) is the largest contributor, followed by Axetil (20-25%), Proxetil (10-15%) and Axetil (5-10%). 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 due to its established operational track record. ICRA also notes that the manufacturing operations of the company are carried out from a single plant location, exposing it to some concentration risk. However, the plant has seven operational blocks, mitigating the risk to a certain extent.

Profitability indicators vulnerable to movement in raw material costs and forex fluctuations – CLPL continues to witness volatility in its profitability indicators due to significant direct/ indirect dependence on imports of raw materials having significant volatility in prices and its limited pricing flexibility, it continues to witness volatility in its profitability indicators. This is also reflected by the improvement in its OPM to 10.2% in FY2024 from 3.6% in FY2023. However, any rise in raw material prices is partially passed on to its customers with a lag of 3-6 months. Further, CLPL's profitability is also exposed to forex fluctuations as ~28% of its FY2024 revenue was generated from exports while also importing a significant proportion 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 agencies such as the US FDA[1], EU GMP[2] and WHO GMP[3], among others. The last inspection of its manufacturing facility by the US FDA was carried out in 2018 and received the establishment inspection report (EIR). The company also remains vulnerable to regulatory changes impacting the business or the industry.

Liquidity position: Adequate

CLPL's liquidity is adequate, supported by steady internal accrual generation, cash and bank balance of Rs. 43.2 crore and unutilised bank facilities of ~Rs. 200 crore as on September 30, 2024. CLPL has a capex commitment of ~Rs. 120-150 crore over the medium term and moderate repayment obligations of ~Rs. 7.5 crore per annum from FY2025 to FY2027. However, its internal accrual generation is expected to be sufficient to service its capex commitments and repayment obligations.

Rating sensitivities

Positive factors – CLPL's ratings may be upgraded if the company is able to improve its revenues and operating margins, supported by the increase in exports, diversification of product profile or benefits from the ongoing backward integration efforts. Moreover, CLPL's ability to maintain a healthy financial profile with a robust capital structure will be key for any upward rating movement.

Negative factors – Pressure on CLPL's ratings could arise with deterioration in its credit metrics, owing to sustained reduction in its revenues and profitability, debt-funded capex, or elongation of its working capital cycle. Specific credit metrics that could lead to a rating downgrade include TOL/TNW of greater than 1.3 times on a sustained basis.

Analytical approach

Analytical Approach	Comments
Applicable rating methodologies	Corporate Credit Rating Methodology Pharmaceuticals
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 antibiotics. 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 manufacturing facility in Medak district in Hyderabad, with an installed capacity of 2,446 metric tonnes per annum (MTPA). The facility is US FDA, EU GMP, WHO GMP and ISO 14001-2004 certified.

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[1] *United States Food and Drugs Administration*

[2] *European Union – Good Manufacturing Practices*

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

Key financial indicators (audited)

CLPL – Standalone	FY2023	FY2024
Operating income	2217.0	2,916.1
PAT	35.0	206.4
OPBDIT/OI	3.6%	10.2%
PAT/OI	1.6%	7.1%
Total outside liabilities/Tangible net worth (times)	1.7	1.2
Total debt/OPBDIT (times)	1.6	0.3
Interest coverage (times)	6.4	42.0

Source: Company, ICRA Research; PAT: Profit after tax; OPBDIT: Operating profit before depreciation, interest, taxes and amortisation; Amount in Rs. crore; All ratios are as per ICRA's calculations

Status of non-cooperation with previous CRA: Not applicable

Any other information: None

Rating history for past three years

	Instrument	Current rating (FY2025)			Chronology of rating history for the past 3 years		
		Type	Amount rated (Rs. crore)	Date & rating in FY2025	Date & rating in FY2024	Date & rating in FY2023	Date & rating in FY2022
				Oct 23, 2024	Jan 03, 2024	Nov 17, 2022	Oct 06, 2021
1	Fund Based – Term Loans	Long term	30.00	**[ICRA]A (Stable)**	[ICRA]A- (Positive)	[ICRA]A- (Stable)	[ICRA]A- (Stable)
2	Fund Based – Working Capital Facilities	Long term	210.00	**[ICRA]A (Stable)**	[ICRA]A- (Positive)	[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	-	-	[ICRA]A-(Positive)/ [ICRA]A2+	-	-
5	Fund Based Limits	Short term	-	-	-	-	[ICRA]A2+
6	Unallocated Limits	Long term	-	-	-	-	[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

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 (Stable)
NA	**Working Capital Facilities**	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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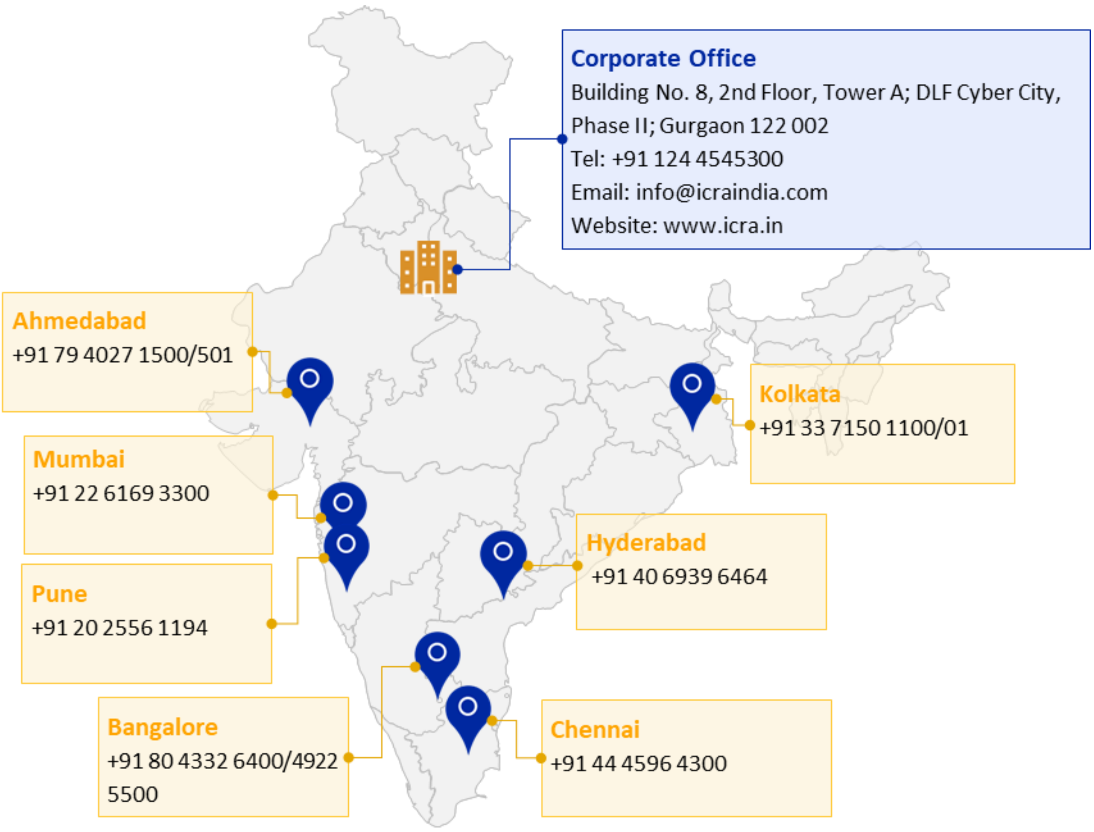

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