

January 10, 2020

Virchow Laboratories Limited: Rating reaffirmed

Summary of rating action

| Instrument* | Previous Rated Amount (Rs. crore) | Current Rated Amount (Rs. crore) | Rating Action |
|---|-----------------------------------|----------------------------------|------------------------------|
| Fund based – Working capital facilities | 50.00 | 50.00 | [ICRA]A+(Stable); reaffirmed |
| Non-fund based limits | 9.00 | 9.00 | [ICRA]A1+; reaffirmed |
| Unallocated limits | 9.00 | - | |
| Total | 68.00 | 59.00 | |

*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 adequate liquidity. The ratings consider the Group's established market position in sulfamethoxazole (SMX) as a leading global producer. It has an established presence in CIS hydroxy lactum (CIS lactum) and trimethoprim (TMP) with a focus to diversify and grow in other sulphur-based antibiotics. The client concentration risk remains low with the top three customers contributing to 10.8% of the revenues in FY2019, coupled with a diversified geographical presence in regulated, semi-regulated and domestic markets. The ratings derive comfort from the vast experience of promoters in manufacturing and marketing mature molecules in the pharmaceutical industry, being a part of the Virchow Group. The revenue base grew by 23.3% YoY in FY2019 led by scale-up in TMP volumes and increase in realisations across SMX, TMP and CIS lactum. The growth in FY2020 is expected to be driven by further increase in TMP volumes, offset by a decrease in SMX and CIS lactum volumes. The decline is due to lower demand offtake from customers, along with plant shutdown for maintenance in October-November 2019. However, the revenues are expected to recover and grow, going forward, with the introduction of new molecules and stabilisation in production and demand for the existing products. The ratings continue to derive comfort from the Group's strong financial profile, characterised by low dependence on external debt with a robust capital and coverage metrics given the adequate cash accruals generation. The key metrics in FY2019 include TD/OPBITDA at 0.3 times (0.3 times in FY2018), interest coverage at 97.5 times (109.7 times in FY2018), TOL/TNW at 0.2 times (0.2 times in FY2018) and NCA/TD at 243.5% (227.9% in FY2018). The Group's capital structure remained healthy despite the share buyback of Rs. 55.0 crore in FY2019 and ~Rs. 40.0 crore in H1 FY2020. Further, the Group is expected to incur a significant capex of ~Rs. 200 crore from FY2020-2022 on the launch of new molecules (in both entities), installation of a cogeneration power unit and effluent treatment plant (ETP) from internal accruals, though the desired level of returns remains to be seen. The Group's coverage indicators are likely to remain comfortable in FY2020, despite a decline in profitability. The Group's liquidity

remained adequate with healthy cash balance and liquid investments of Rs. 95.6 crore as on March 31, 2019 (Rs. 17.8 crore as unencumbered cash and Rs. 77.8 crore in liquid mutual funds) and surplus unutilised working capital limits.

The Group's operating and net margins were under pressure in FY2019 owing to modest demand from customers and rising raw material costs. With a decrease in revenues in FY2020, the margins are expected to moderate slightly. However, the Group's profitability is supported by its large capacities for SMX and resultant benefits from the economies of scale, coupled with operating efficiencies emanating from the backward integration of operations for SMX. The margins remain exposed to fluctuations in raw material prices, as witnessed in FY2019, owing to limited pricing flexibility. The ratings remain constrained by the continued high product concentration, with SMX accounting for approximately 54.8% of the Group's revenues and the dependence on mature molecules, which restricts growth prospects. Further, the company remains exposed to regulatory risks including price control, anti-dumping duties, pollution control and product quality risks inherent in the industry.

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 of Companies, 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. The Group has an established presence in CIS lactum and TMP with a focus to diversify and grow in other sulphur-based antibiotics.

Diversified geographical presence and wide customer base – Exports contributed to 46.8% of the revenues in FY2019, with sales distributed across regulated, semi-regulated Asian and African markets and domestic markets. VLL primarily caters to the regulated and semi-regulated markets, whereas AOL caters to demand from domestic and semi-regulated markets. The Group has an established and reputed customer base comprising traders and end-use companies, with the top three customers accounting for 10.8% of sales in FY2019.

Strong capital structure and coverage indicators despite share buyback and significant capex in medium term – The Group's capital structure and coverage metrics remained healthy, driven by healthy accruals, limited investments towards capex in the past and low dependence on long-term funding. The Group's gearing remained healthy at 0.1 times in FY2019 (0.1 times in FY2018), while its TD/OPBITDA stood at 0.3 times in FY2019 (0.3 times in FY2018), with interest coverage of 97.5 times in FY2019 (109.7 times in FY2018) and TOL/TNW of 0.2 times in FY2019 (0.2 times in FY2018). The capital structure remains strong, despite the share buyback of Rs. 55.0 crore in FY2019 and ~Rs. 40 crore in H1 FY2020. It is expected to incur a significant capex of ~Rs. 200 crore from FY2020-2022 on the launch of new molecules and installation of a cogeneration and ETP plant, to be funded through internal accruals. However, the Group's capital structure and coverage indicators are likely to remain comfortable in FY2020, despite a decline in profitability due to healthy accruals and low dependence on long-term bank debt.

Credit challenges

High product concentration risk – The product concentration for the Group remains high with top three products contributing to 82.3% of the revenue profile. Dependence on SMX remained high over the years, which accounted

for 54.8% of the Group's revenues in FY2019. While it has reduced from its peak levels of 79.6% in FY2013 with the launch of other products such as TMP (16.4% of FY2019 revenues) and CIS lactum (11.1% of FY2019 revenues), high concentration towards a mature molecule like SMX has limited the Group's growth potential. While the scale up in TMP is expected to support revenues in the near term, the reducing volumes of SMX and CIS lactum are likely to moderate the positive impact on its revenue growth and earnings. Therefore, diversification into new molecules remains important for the company's future growth prospects.

Volatility in operating margins owing to raw material prices and limited pricing flexibility – The Group's operating and net margins declined in FY2019 to 15.1% and 10.4% from 17.1% and 11.5%, respectively, in FY2018. The decline in margins is owing to an increase in key raw material prices, with the Group's limited pricing flexibility considering its mature product portfolio. Despite an increase in realisations across key products (SMX, TMP and CIS lactum), some raw material costs were absorbed by the company due to modest demand. The raw material costs depend on the market situation and demand, which are either absorbed by the Group or passed on to customers with a lag of three to six months. With a decline in revenues in FY2020, the margins are expected to moderate slightly. The margin profile is likely to improve from FY2021 with stabilisation in the existing product portfolio, export of TMP to regulated markets (post USFDA approval) and introduction of new molecules. Although the Group continues to be reliant on imports for meeting a considerable portion of its raw material requirements, sizeable exports mitigate the foreign exchange fluctuation risk to some extent.

Liquidity position: Strong

The Group's liquidity is strong with healthy accruals of Rs. 90.6 crore and fund flow from operations of Rs. 79.3 crore in FY2019. The cash flows generated have been utilised to meet the working capital requirements, capex funding and sizeable payouts to promoters in the form of dividends or share buyback, with the rest being parked in liquid investments and bank deposits. The liquidity profile remained supported by the healthy cash balance and liquid investments of Rs. 95.6 crore as on March 31, 2019 (Rs. 17.8 crore as unencumbered cash and Rs. 77.8 crore in liquid mutual funds). Further, the Group reported a low average working capital utilisation of 2.7% for the 12 months that ended in October 2019. The Group has no long-term debt. It has modest capex commitment of ~Rs. 35 crore in FY2020 (to be financed by internal accruals) that is expected to increase in FY2021-2022 in order to diversify its product portfolio.

Rating sensitivities

Positive triggers – ICRA could upgrade the Group's rating if it diversifies its product portfolio, thereby reducing 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 triggers – Negative pressure on the rating could arise if the company's operating profitability declines below 12% on a sustained basis or if there is any major debt-funded capital expenditure or higher-than-expected withdrawals from promoters without corresponding surpluses. Specific credit metrics that could lead to a downgrade is TD/OPBITDA exceeding 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 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

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 three subsidiaries: AOL, Virchow Healthcare Private Limited (VHPL) and Virchow Drugs Limited (VDL, rated at [ICRA]BBB+(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)) and TMP (used as a synergic combination with SMX to make co-trimoxazole), besides sulfamethoxazole.

Key financial indicators (audited)

| | VLL | | AOL | | Consolidated* | |
|--|--------|--------|--------|--------|---------------|--------|
| | FY2018 | FY2019 | FY2018 | FY2019 | FY2018 | FY2019 |
| Operating Income (Rs. crore) | 334.0 | 371.9 | 496.3 | 627.1 | 758.7 | 935.1 |
| PAT (Rs. crore) | 22.4 | 31.0 | 64.7 | 66.5 | 87.1 | 97.5 |
| OPBDIT/OI (%) | 10.01% | 11.82% | 19.47% | 15.46% | 17.14% | 15.07% |
| RoCE (%) | 12.94% | 20.32% | 20.89% | 19.50% | 17.95% | 19.89% |
| Total Outside Liabilities/ Tangible Net Worth (times) | 0.1 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| Total Debt/OPBDIT (times) | 0.5 | 0.5 | 0.3 | 0.3 | 0.3 | 0.3 |
| Interest Coverage (times) | 67.7 | 73.3 | 139.7 | 114.7 | 109.7 | 97.5 |
| DSCR | 55.1 | 59.4 | 88.7 | 69.2 | 76.5 | 65.8 |

*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 Virchow Laboratories Limited on July 20, 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 (FY2020) | | | Rating History for the Past 3 Years | | | | |
|---|-----------------------------------|-------------------------|--------------|--------------------|-------------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|-----------------------------------|
| | | Type | Amount Rated | Amount Outstanding | Rating | FY2019 | | FY2018 | FY2016 |
| | | | | | 10-Jan-2020 | 15-Oct-2018 | 12-Jul-2018 | 5-Apr-2017 | 30-Mar-2016 |
| 1 | Working capital facility | Long Term | 50.00 | - | [ICRA]A+ (Stable) | [ICRA]A+ (Stable) | [ICRA]A+ (Stable) | [ICRA]A+ (Stable) | [ICRA]A+ (Stable) |
| 2 | Letter of Credit & Bank Guarantee | Short Term | 9.00 | - | [ICRA]A1+ | [ICRA]A1+ | [ICRA]A1+ | [ICRA]A1+ | [ICRA]A1+ |
| 3 | Unallocated | Long term/short term | - | - | - | [ICRA] A+ (stable)/ [ICRA] A1+ | [ICRA] A+ (stable)/ [ICRA] A1+ | [ICRA] A+ (stable)/ [ICRA] A1+ | [ICRA] A+ (stable)/ [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 | 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 | 50.00 | [ICRA]A+(Stable) |
| NA | Non-fund based facility | NA | NA | NA | 9.00 | [ICRA]A1+(Stable) |

Source: Company

Annexure-2: List of entities considered for consolidated analysis

| Company Name | Ownership | Consolidation Approach |
|-------------------------|-----------|------------------------|
| Andhra Organics Limited | 100.00% | Full Consolidation |

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