Neuland Laboratories Limited

January 30, 2019

Ratings

Instrument*	Amount (Rs. Crore)	Ratings	Remarks
Long-term Bank Facilities	303.52	**CARE BBB+; Negative (Triple B Plus; Outlook: Negative)**	Reaffirmed
Short-term Bank Facilities	118.90	**CARE A3+ (A Three Plus)**	Reaffirmed
Total Facilities	**422.42 (Rs. Four Hundred Twenty-Two Crore and Forty-Two lakhs Only)**		

**Details of instruments/facilities in Annexure-1*

Detailed Rationale

The ratings assigned to the bank facilities of Neuland Laboratories Limited (NLL) continues to derive strength from experienced management, approved manufacturing facilities by regulatory authorities of regulated markets, capacity expansion through acquisition of manufacturing facility of Arch Pharma Labs Limited (APL), diversified product portfolio, reputed and established clientele. The ratings also factors in the successful completion of inspection by US FDA (Unit II located in Pashamylaram, Hyderabad) with no observations, improvement in liquidity profile with infusion of funds by way of qualified institutional placement (QIP) issue during May 2018. The ratings are, however, tempered by decline in total operating income and profitability margins during FY18 (refers to the period April 1 to March 31) with further deterioration in profitability margins during H1FY19, weakening of capital structure as on March 31, 2018 albeit improved as on September 30, 2018 due to QIP issue, deterioration in other debt coverage indicators and elongated operating cycle during FY18, risk associated with exchange rate fluctuation and exposure to regulatory risk.

The ability of the company to grow its revenue base and improve profitability margins, to efficiently manage its working capital requirements and its ability to timely complete repairs & refurbishment along with obtaining regulatory approvals and commence operations from its newly acquired manufacturing facility of Arch Pharma Labs Limited (APL) without availing any further external debt and thus reducing its reliance on China for procuring key intermediates shall be the key rating sensitivities.

Outlook: Negative

The negative outlook on rating of NLL reflects significant decline in the operating profit level and margin during FY18 & H1FY19 with significant increase in input prices which could not be passed on to its customers and the possibility of further deterioration for the projected period. The outlook may be revised to stable if the company is able to execute the pending high margin orders and derive benefit from the backward integration unit thereby shielding the margins.

Detailed description of the key rating drivers

Key Rating Strengths

Experienced management and approved manufacturing facilities

NLL is led by Dr. D.R. Rao, the Chairman and MD of the company, who has over four decades of industry experience. He has a Masters in Science from Andhra University, Post Graduate Diploma in Technology from IIT Kharagpur, and was awarded his PhD in Organic Chemistry from the University of Notre Dame, U.S.A. He is a member of Royal Society of Chemistry. He is ably supported by Mr. Mr. Davuluri Sucheth Rao and Mr. Davuluri Saharsh Rao. Mr. Davuluri Sucheth Rao, Vice-Chairman and Chief Executive Officer, has been actively involved in managing NLL since 2002, initially as Chief Operating Officer (COO) and then as CEO. Mr. Davuluri Saharsh Rao, Joint Managing Director, joined NLL in 2007, with responsibility for initiating the Custom Manufacturing Solutions (CMS) business. He is currently responsible for all Marketing, Business Development activities along with oversight of R&D. NLL has manufacturing facilities compliant with health and regulatory agencies cGMP certifications namely, USFDA (USA), Canada (HC), PMDA (Japan), KFDA (Korea), EU (EMA), EDQM (COS) and others (ROW).

Diversified product portfolio

NLL has portfolio of 86 products (largely APIs) as on December 31, 2018 (as against 78 as on March 31, 2017). Ciprofloxacin and Levetiracetam, the flagship products of NLL continued to remain the major revenue contributor in FY18 with 19.90% share in total operating income against 22.07% share in FY17. NLL has been generating about 85% of its Total operating income from API's and remaining about 15% from Contract Manufacturing Services (CMS). With increased focus on CMS business, NLL is shifting towards low volume high margin products. The top 10 products contributed about 43.69% in FY18 against 57.55% in FY17. Further, to diversify its product portfolio the company has launched new products and has entered new market regions during FY18.

Reputed and established clientele

The company has been generating revenue from customers with long standing relation with an average age of 15 years of association. The company enjoys dependable relationships with major global and Indian pharma majors. The company has established healthy relationship with reputed clients such as Teva Pharmacutical Industries, Aurobindo Pharma Ltd, Mylan Laboratories Ltd and Azad Pharma among others. The established relations have also resulted in repeat orders from customers. No single client contributes more than 16% to the total operating revenue. Further, Top 5 clients of the company accounted for 32% during FY18 against 26.22% in FY17.

Capacity expansion through acquisition of Arch Pharma Labs Limited

The company has acquired manufacturing facility of Arch Pharma Labs Limited (APL) on December 13, 2017 which is located at Gaddapotharam Village, Medak District near Hyderabad with an installed capacity of 197 KL. The total cost of acquisition is Rs. 118.88 crore funded through term loans of Rs. 90.20 crore, monetization of non-current investment of Rs. 20.08 crore (Nanakramguda property, Hyderabad) and internal accrual of Rs. 8.00 crore. APL has 5 production blocks for advance intermediates and API manufacturing with 70 reactors. Post-acquisition, total installed capacity of the NLL has increased from 532.70 KL (222.50 KL in unit I and 310.20 KL in unit II) to 729.70 KL.

Moderate liquidity position

During FY18, liquidity profile of the company remained moderate with current ratio of 1.17 as on March 31, 2018. However, post QIP the liquidity profile of the company improved significantly as the company raised Rs. 125.63 crore from the issue and utilized the proceeds for pre – payment of part of its long term debt amounting to Rs. 37.88 crore and balance of Rs. 87.75 crore is to be utilized for capex and working capital requirements. Further, the company had free cash and bank balance of Rs. 19.74 crore as on Dec 31, 2018. Further, the company has additional liquidity comfort with availability of Rs. 12 crore of CC as the company has presently availed Rs. 208.00 crore of CC out of the total sanctioned limit of Rs. 220.00 crore.

Key Rating Weaknesses

Decline in total operating income during FY18 albeit rebounding during H1FY19

At consolidated level, the total operating income of the company has witnessed an 8.75% decline during FY18. The total operating income declined from Rs. 579.94 crore during FY17 to Rs. 529.17 crore during FY18 due to reduction in contribution from Ciprofloxacin and low volume high margin Custom manufacturing solutions (CMS) segment. The revenue from Ciprofloxacin has declined from Rs. 86.81 crore during FY17 to Rs. 58.03 crore during FY18. During H1FY19, the company has recorder 29.75% growth in total operating income from Rs. 250.04 crore in H1FY18 to Rs. 324.45 crore in H1FY19.

Decline in Profitability margins during FY18 and H1FY19

During FY17, high PBILDT margin was led by strong volumes of Salmeterol, Ciprofloxacin, Levetiracetam and increased revenue from CMS segment which is a low volume high margin business. During FY18, the profitability margins represented by PBILDT margin and PAT margin of the company deteriorated significantly from 18.54% and 8.08% during FY17 to 9.89% and 2.28% respectively. The decline was due to decrease in sales from high volume business such as Salmeterol, Ciprofloxacin and other high margin CMS products on account of lower offtake from its clients. Moreover, increase in major raw material costs is also attributable to decline in PBILDT margins during FY18. During H1FY19, PBILDT margin declined to 7.82% due to further increase in raw material prices. However, foreseeing the aforementioned scenario with respect to rise in raw material prices by China, the company had already started backward integration for production of the intermediaries. The company has identified the key raw materials/ intermediates required in production of Dorzolamide, Mirtazapine & Levetiracetam which are the prime intermediates that the company uses to manufacture its products. Apart from in house production the company has also started procuring the raw materials from alternate sources by diversifying the vendor portfolio. Further, CMS segment being a high margin business is expected to clock turnover of about Rs. 106.00 crore during FY19. Out of which the company has only executed orders amounting to Rs. 55.00 crore till December 31, 2018 and the remaining about Rs. 50 crore of orders are expected to be delivered during Q4FY19. Thus the execution of aforementioned CMS orders forms the critical factor from credit risk point of view.

Deterioration in overall gearing as on March 31, 2018 albeit improved as on September 30, 2018 due to QIP issue:

During FY18, the overall gearing of the company has deteriorated from 0.88x as on March 31, 2017 to 1.26x during March 31, 2018. The deterioration was mainly due to increase in term loans availed during the year. Overall gearing of the company however has improved as on September 30, 2018 to 0.64x which is primarily attributed to QIP issue. The company has utilized the aforementioned amount for pre – payment of part its long term debt amounting to Rs. 37.88 crore and balance of Rs. 87.75 crore is to be utilized for capex and working capital requirements.

Deterioration in debt coverage indicators:
Increase in debt levels due to acquisition of new unit combined with decline in profits levels during FY18 has led to deterioration in debt coverage indicators. The total debt to GCA and PBILDT interest coverage deteriorated from 3.06x and 5.10x as on March 31, 2017 to 10.92x and 2.77x as on March 31, 2018 respectively.

Elongated operating cycle
The total operating cycle of the company elongated from 129 days during FY17 to 169 days mainly due to increase in collection days and inventory days. The company is maintaining inventory of regular products and raw material for 90-120 days to avoid stock-out issues and providing about 80-100 days of credit period to its customer. The average of maximum working capital utilization of the company for the last twelve months ending on November 2018 has been moderate at 77.96%. Nevertheless the collection period of the company has improved as on September 30, 2018 with the average collection days at 111 days as on September 30, 2018 against 131 days as on March 31, 2018.

Risk associated with exchange rate fluctuations
The total operating income of the company constitutes about 74% from export sales during FY18 (as against about 76% during FY17). Further the company has imported raw material of Rs. 76.34 crore which is about 27.58% of total raw material purchases during FY18. Accordingly NLL has natural hedge against exchange rate fluctuations to certain extent. Further, towards its hedging policy, the company is issuing bill discounting and Pre-shipment Credit in Foreign currency (PCFC) to cover about 85% of the total risk while 15% remains open. Further the company reviews and evaluates the same on a quarterly basis.

Exposure to regulatory risk
The pharmaceutical industry is highly regulated and requires various approvals, licenses, registrations and permissions for business activities. Each authority has its own requirement and they could delay or refuse to grant approval, even when a product has already been approved in another country. The approval process for a new product registration is complex, lengthy and expensive. The time taken to obtain approval varies by country but generally it takes from six months to several years from the date of application. Any delay or failure in getting approval for new product launch could adversely affect the business prospect of the company.

Analytical approach: consolidated
The consolidated business and financial risk profiles of Neuland Laboratories Ltd (NLL) and its subsidiaries namely Neuland labs Inc. (USA) and Neuland Labs K.K (Japan) have been considered as these companies are subsidiaries of NLL which provide marketing support services to NLL and have financial and operational linkages.

Applicable Criteria
Criteria on assigning Outlook to Credit Ratings
CARE's Policy on Default Recognition
Criteria for Short Term Instruments
Rating Methodology-Manufacturing Companies
Financial ratios – Non-Financial Sector
Rating Methodology- Pharmaceutical Sector

About the Company
Neuland Laboratories Ltd (NLL) was set up as a private limited company in 1984 by Dr. D R Rao and Mr. G V K Rama Rao and it was reconstituted as a public limited company, with the current name, in 1994. NLL is primarily into manufacturing of active pharmaceutical ingredients for global pharmaceutical companies and also provides end-to-end solutions for the pharmaceutical industry for chemistry-related services from synthesis of library compounds to supply of New Chemical Entities (NCEs) and intermediates at various clinical phases up to commercial scale.
NLL has three manufacturing facilities in and around Hyderabad, Telangana with total installed capacity of 729.70 Kilo Litre as on March 31, 2018 (222.50 KL in unit I, 310.20 KL in unit II and 195 KL in Unit III). The company has portfolio of around 86 products with presence in 25 therapeutic segments including Cardio Vascular, CNS, Ophthalmic, Antibacterial, Antidepressant, Bronchodilator, Anticonvulsant, Antipsychotics, Antiparkinsonian, Antihypertensive and Anatomical.
NLL is listed on the Bombay Stock Exchange (BSE) and National Stock Exchange (NSE). During FY18, the company received approvals from National Company Law Tribunal (NCLT) for amalgamation with its parent company (Neuland Health Sciences Private Limited, NHSPL) and it's associate (Neuland Pharma Research Private Limited, NPRPL).

Brief Financials (Rs. crore)	FY17 (A)	FY18 (A)
Total operating income	579.94	529.17
PBILDT	107.52	52.36
PAT	46.86	12.06
Overall gearing (times)	0.73	1.16
Interest coverage (times)	5.10	2.77

Status of non-cooperation with previous CRA: Not Applicable
Any other information: Not Applicable
Rating History for last three years: Please refer Annexure-2

Note on complexity levels of the rated instrument: *CARE has classified instruments rated by it on the basis of complexity. This classification is available at www.careratings.com. Investors/market intermediaries/regulators or others are welcome to write to care@careratings.com for any clarifications.*

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Annexure-1: Details of Instruments/Facilities

Name of the Instrument	Date of Issuance	Coupon Rate	Maturity Date	Size of the Issue (Rs. crore)	Rating assigned along with Rating Outlook
Term Loan-Long Term	-	-	March 2026	83.52	CARE BBB+; Negative
Fund-based - LT-Working Capital Limits	-	-	-	220.00	CARE BBB+; Negative
Non-fund-based - ST-BG/LC	-	-	-	112.50	CARE A3+
Non-fund-based - ST-Forward Contract	-	-	-	6.40	CARE A3+

Annexure-2: Rating History of last three years

Sr. No.	Name of the Instrument/Bank Facilities	Current Ratings			Rating history			
		Type	Amount Outstanding (Rs. crore)	Rating	Date(s) & Rating(s) assigned in 2018-2019	Date(s) & Rating(s) assigned in 2017-2018	Date(s) & Rating(s) assigned in 2016-2017	Date(s) & Rating(s) assigned in 2015-2016
1.	Term Loan-Long Term	LT	83.52	CARE BBB+; Negative	-	1)CARE BBB+; Stable (27-Feb-18) 2)CARE BBB+; Stable (07-Feb-18) 3)CARE BBB+; Stable (11-Apr-17)	1)CARE BBB (26-Aug-16) 2)CARE BBB- (29-Apr-16)	1)CARE BBB- (16-Sep-15) 2)CARE BBB- (07-Aug-15)
2.	Fund-based - LT-Working Capital Limits	LT	220.00	CARE BBB+; Negative	-	1)CARE BBB+; Stable (27-Feb-18) 2)CARE BBB+; Stable (07-Feb-18) 3)CARE BBB+; Stable (11-Apr-17)	1)CARE BBB (26-Aug-16) 2)CARE BBB- (29-Apr-16)	1)CARE BBB- (16-Sep-15) 2)CARE BBB- (07-Aug-15)
3.	Non-fund-based - ST-BG/LC	ST	112.50	CARE A3+	-	1)CARE A3+ (27-Feb-18) 2)CARE A3+ (07-Feb-18) 3)CARE A3+ (11-Apr-17)	1)CARE A3+ (26-Aug-16) 2)CARE A3 (29-Apr-16)	1)CARE A3 (16-Sep-15) 2)CARE A3 (07-Aug-15)
4.	Non-fund-based - ST-Forward Contract	ST	6.40	CARE A3+	-	1)CARE A3+ (27-Feb-18) 2)CARE A3+ (07-Feb-18) 3)CARE A3+ (11-Apr-17)	1)CARE A3+ (26-Aug-16) 2)CARE A3 (29-Apr-16)	1)CARE A3 (16-Sep-15) 2)CARE A3 (07-Aug-15)

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