Natural Capsules Limited

Pharmaceuticals

ICRA

Credit Perspective

May 2019

RATING ACTION

Rating reaffirmed

Long - Term Rating

[ICRA]BBB (Stable)

Short - Term Rating

[ICRA]A3+

Total Limits Rated

Rs. 12.49 crore

Rating Rationale

The ratings reaffirmation considers Natural Capsules Limited's (NCL) long presence in the Empty Hard Gelatin Capsule (EHGC) manufacturing industry, the diversified product profile and the long-standing relationships with its customers. The ratings factor NCL's revenue growth in FY2019 aided by higher sales volumes and improvement in capsule realisations. The ratings continue to positively factor in the company's comfortable capital structure and coverage indicators.

The ratings, however, are constrained by the relatively high working capital intensity of operations, as measured by NWC/OI of ~46% in FY2019, owing to the stretched collection period and high inventory-holding levels. The ratings continue to be constrained by the declining export revenues and intense competition in the international markets, restricting the company's revenue growth and margins. ICRA also notes that the company's profit margins remain exposed to volatilities in the raw material prices.

ICRA also takes note of the company's capital expenditure plans over the next two fiscals towards diversification into manufacturing of Active Pharmaceuticals Ingredients (API) as well as expansion and upgradation of its capsules manufacturing capacity. The total capital expenditure is estimated to be around ~Rs. 42.00 crore which is proposed to be funded through a term loan of Rs. 27.50 crore. For the remaining amount, the company plans to sell part of the land it holds, reduce its working capital cycle and use its internal accruals. The sizeable capital expenditure exposes the company to execution risks of cost and time overruns. Further, this debt funded capex is likely to impact the capital structure and coverage indicators to some extent, although they are expected to remain comfortable.

Going forward, the ability of NCL to commence operations within the budgeted cost, develop stable customer base for the new product, and ramp up operations and generate cashflows in a timely manner, would remain key rating sensitivities. ICRA would continue to monitor the progress of the land sale, which is critical for funding the capex. ICRA will also monitor the progress of the planned capital expenditure and the impact of the same on the liquidity and financial profile of NCL.

Rating Outlook

The Stable outlook reflects ICRA's expectation that NCL will continue to benefit from the extensive experience of its promoters and the established market position in the capsules business.

Scenarios for Rating Upgrade

Substantial growth in revenue and profitability and efficient working capital management, strengthening the financial risk profile will be the key for a higher rating.

Scenarios for Rating Downgrade

Downward pressure on the ratings could emerge in case of higher-than-anticipated capital expenditure leading to weakening of the company's liquidity position and/or capital structure.

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Key Rating Considerations

Credit Strengths

- Long presence of NCL in the EHGC industry
- Comfortable capital structure and coverage indicators in FY2019
- Diversified customer profile

Credit Challenges

- High working capital intensity as indicated by NWC/OI of ~46% in FY2019
- Intense competition in the industry from national and international players
- Exposed to volatilities in raw material prices
- Exposed to cost and time overrun risks with respect to the capex

Company Profile

NCL, headquartered in Bangalore, primarily manufactures Empty Hard Gelatin Capsule (EHGC) shells and Empty Hard Cellulose Capsule (EHCC) shells. The company has one manufacturing unit in Bangalore and another in Pondicherry with an aggregate capacity of 7.2 billion capsule shells per annum and caters to both domestic and international markets. NCL's product mix comprises various capsule shells such as Hard Gelatin Capsule Shells, Hard Cellulose Capsule Shells, BSE/TSE Free Gelatin Capsule Shells, Shiny Gelatin Capsule Shells, SLS free Gelatin Capsule Shells, Halal Certified Gelatin Capsule Shells, Fortified Gelatin Capsule Shells, Sweet Gelatin Capsule Shells and Fast Release Gelatin Capsule Shells, among others. Going forward, it plans to set up a third manufacturing unit and diversify into API manufacturing.

BUSINESS RISK PROFILE

Long experience of NCL in the EHGC industry with extensive product portfolio; demand and realizations revival in the domestic markets resulting in improved revenues

The company manufactures gelatine and vegetable capsules and caters to a large number of renowned customers in the domestic and export markets. It has a large product portfolio with more than 10 different varieties of capsules available in about seven standard sizes, manufactured based on the requirement of the customers. The major product categories for NCL are hard gelatin capsule shells, hard cellulose capsule shells, bse/tse free gelatin capsule shells, shiny gelatin capsule shells, sls-free gelatin capsule shells, halal- certified gelatin capsule shells, fortified gelatin capsule shells, sweet gelatin capsule shells and fast-release gelatin capsule shells, among others. NCL has strong manufacturing capabilities with WHO-GMP certifications and established market position in the domestic and export markets.

NCL has twenty capsule making lines, out of which nineteen are dedicated for manufacturing EHGC capsules and one for Hydroxypropyl Methylcellulose (HPMC) - veg capsule. The company has an aggregate capacity of 7.2 billion capsules per annum. With improvement in the demand, the capacity utilization improved in FY2018 and FY2019 and the sales volumes improved by ~8% in FY2019. The sales realisation, albeit low, marginally improved in FY2019. Overall, the revenues improved in FY2019, supported by improved domestic demand.

Major portion of the revenues continues to be derived from the domestic market

The sales to the domestic market improved by 19% in FY2019 in comparison to the previous year. The domestic market contributed to 86% of the total revenues in FY2019, as against 79% in FY2018. However, the export revenues declined by ~28% in FY2019 with subdued demand conditions. The overall export revenues have declined significantly over the past 12-15 months on account of subdued demand and weak realisations in the export markets, coupled with intense competition from Chinese players.

Diversified customer profile, new customer addition supports the sales volumes

NCL caters to a large number of renowned customers. At present, some of the company's large customers in the domestic market include Sterling Labs Private Limited, Kopran Limited, Milan Laboratories India Private Limited, Bhojwani Universal, among others. It has added new customers like Impulse Pharma Pvt Ltd., Caplin Point Laboratories Ltd, Golden Capsules Ltd, Yelluri Formulations Pvt Ltd, Y L Pharma etc in FY2018 and FY2019. Its top five customer in the domestic market accounted for about 20% of its total domestic revenues in FY2019. The company caters to about ~28-30 countries across Europe, Africa, the US, the Middle-east and SAARC regions, resulting in significant diversification across customers as well as geographies. In the export market, the company's customer profile is a mix of both distributors as well as end customers (pharmaceutical companies). However, the overall export revenues have declined in FY2019.

Bulk of gelatin procurement from domestic suppliers

The most important raw material in the gelatin capsule manufacturing is pharma-grade gelatin. The company sources a major portion of its gelatin requirements from the domestic suppliers. Some of its key suppliers include Sterling Biotech Limited, Pioneer Jellice India Private Limited, Narmada Gelatines Limited and Nithya Packaging Private Limited, among others. NCL has long established relationship with its suppliers. However, the prices of raw materials increased after shutdown of the manufacturing unit of NCL's major supplier, which impacted the profit margins in Q2 FY2019. The company passed on the increased input prices partially to the customers from August 2018. Overall, its profitability remains exposed to the volatilities in the raw material prices.

Competitive intensity remains high on account of fragmented nature of the business

NCL faces intense competition in the international markets, mainly from Chinese players, restricting the company's pricing flexibility and impacting its realisations and margins. In the domestic market as well, it faces competition from other established players like Associated Capsules Private Limited, Sunil Health Care Limited, Medi-Caps Limited and Healthcaps India Limited, among others. The competition from the unorganised players is also high. Owing to stiff competition, NCL's ability to pass on the increase in raw material prices to its customers gets limited.

Presence in manufacturing of extracts and formulations through equity investment in Supreem Pharmaceuticals Mysore Private Limited

The company invested in a Mysore-based pharmaceutical firm called Supreem Pharmaceuticals Mysore Private Limited (SPMPL) to acquire 40% stake for ~Rs. 11.5 crore (Rs. 5.0 crore has been paid) funded through equity investments by promoters and other high net worth individuals in FY2016. The remaining investment has not yet been made as it would be subject to SPMPL achieving certain operational and financial targets. SPMPL is engaged in the manufacturing of wide range of bulk stabilized vitamins, herbal extracts and formulations, food supplements, tasteless minerals and active pharmaceutical ingredients and has been in the pharmaceutical business for more than three decades.

FINANCIAL RISK PROFILE

Growth in the revenues with improvement in domestic demand; however, margins impacted by low realizations and increase in raw material costs

The revenues improved by ~10% to Rs. 60.01 crore in FY2019 from Rs. 54.76 crore in FY2018. The revenue growth was supported by increased sales volumes in the domestic market. The operating margins declined to 8.75% in FY2019 from 10.11% in FY2018. This was owing to increase in raw material and power expenses. The prices of raw materials increased after shutdown of the manufacturing unit of NCL's major supplier. Further, the sales realizations, albeit improvement, continue to be low. The NPM improved to 3.17% in FY2019 from 2.04% in FY2018, supported by non-operating income and lower depreciation. Return on capital employed, albeit improvement, continues to be low at 4.55%.

Comfortable capital structure and coverage indicators

The company has no outstanding term loan as on March 31, 2019. It has utilised internal accruals to fund the capital expenditure in the last three-four years. NCL's capital structure and coverage indicators were comfortable with no long-term debt and moderate working capital borrowings. The gearing stood low at 0.10 times as on March 31, 2019. The interest coverage stood at 9.92 times, DSCR at 10.15 times and NCA/TD at 75% in FY2019. However, the same is expected to witness some deterioration given the significant debt-funded capex on the anvil.

Working capital intensity remains high owing to stretched collection periods from its customers

The working capital intensity of NCL, as measured by NWC/OI, remained high at ~46% in FY2019 owing to the long collection period offered to its customers, coupled with higher inventory holding levels. NCL provides a 60-90-days credit period to its domestic customers while its international customers provide letter of credit with 90 to 120 days of credit period which results in a stretched collection cycle. In addition, the collection cycles invariably remain on the higher side across the industry as higher credit period is offered to boost sales amid bleak demand scenario. The company receives a credit period of about 60-90 days from its suppliers, which was stretched in FY2019. The company maintains raw material inventory of around a month.

Free cash flows impacted with capital expenditure in FY2019

The company's fund flow from operations stood at Rs. 3.93 crore in FY2019 and declined in comparison to previous year with high operating costs. The retained cash flows stood at Rs. 3.57 crore. It incurred capex of Rs. 8.58 crore in FY2019 which resulted in free cash outflows of Rs. 5.01 crore. The deficit was funded through increase in working capital borrowings.

CAPITAL EXPENDITURE AND FUNDING PLANS

Capital expenditure for capacity expansion

The company has large capital expenditure plans to diversify into manufacturing of APIs. It is also setting up a new unit in Tumkur. It would incur an additional capital expenditure of Rs. 35.37 crore over the next two fiscals towards this, which will be funded through term loans of Rs. 27.50 crore and the balance through internal accruals. The company plans to complete construction of the unit and start manufacturing from September 2020. The significant capex exposes the company to project-related risks. Further, the company has capital expenditure plans for expansion and upgradation of its capsules manufacturing capacity at a cost of Rs. 2.50-3.00 crore.

DEBT REPAYMENT AND LIQUIDITY PROFILE

The company, at present, has working capital limits of Rs. 6.50 crore, the average utilisation of which remained comfortable at 59% for the period April 2018 to March 2019. It has no repayment obligations on term loans as on date. However, going forward, term loan borrowings for funding the capital expenditure will increase the debt repayment obligations. Going forward, in the light of a significant capital expenditure, the liquidity position of the company remains dependent on the timely monetisation of land and reduction in working capital cycle.

EXHIBIT 1: Trend in Debt Repayments

In Rs. crore	FY2019P	FY2020P	FY2021P
Annual Debt Repayments	-	-	0.92*

Source: Company data, ICRA research
**Repayment towards new term loan*

BUSINESS AND FINANCIAL OUTLOOK

The empty capsules market is a key part of the global pharmaceutical industry and is likely to exhibit steady growth in the coming years due to the rapid proliferation of the pharmaceuticals sector in developing regions. The upward trajectory of all aspects of the healthcare sector is likely to remain a vital driver for the market in the coming years. The company's ability to pass on raw material price hikes to customers will be critical determinant of its profitability. The company is expected to commence the operations for the API product in FY2021, which will support revenue growth over the long term.

EXHIBIT 2: Financial Outlook

Parameters	ICRA's Comments
Revenue Growth	Expected to register ~7% growth for FY2020. API sales expected to start in FY2021 resulting in healthy growth in revenues.
Profitability Indicators	Expected to remain in line with FY2019, and improve from FY2021 onwards with commencement of API manufacturing operations
Repayment Obligations	Proposed term loan of Rs. 27.50 crore for capital expenditure funding. It is expected to have moratorium period of 18 months. Repayment to start from Q4 FY2021. No repayment obligations for FY2020.
Capital Expenditure Plans	**Diversification:** Project cost estimated to be Rs. 42-43.00 crore for setting up unit for steroids manufacturing plant in Tumkur. The company has incurred Rs. 6.80 crore towards this in FY2019, funded through internal accruals. The balance Rs. 35.37 crore to be incurred in FY2020 and FY2021. Funding through term loans of Rs. 27.50 crore and balance through internal accruals. **Expansion:** Capex of ~Rs. 2.50-3.00 crore to be incurred in FY2020 and FY2021 towards capacity expansion of the capsule manufacturing business. To be funded through internal accruals.
Leverage and Coverage Indicators	The debt levels will increase from the current levels on the back of planned capex.
Working Capital Intensity	Expected to reduce from the current levels as the management focusses on bringing down the level of receivables.
Retained Cash Flows	Likely to improve in FY2020 onwards aided by lower working capital intensity
Liquidity	Expected to remain moderate supported by moderate utilisation of working capital facilities. Going forward, in the light of a significant capital expenditure, the liquidity position of the company remains dependent on the timely monetisation of land and reduction in working capital cycle.

Source: Company data, ICRA research

PROMOTER AND MANAGEMENT PROFILE

NCL is managed by Mr. Sunil Mundra, who is a Chartered Accountant with over 25 years of experience in the pharmaceutical industry.

Annexure I: Key Financial Indicators

In Rs. crore	FY2015	FY2016	FY2017	FY2018	FY2019 P
Revenue & Profitability Indicators					
Operating Income (OI)	67.32	62.05	53.64	54.76	60.01
Growth in OI (%)	15%	-8%	-14%	2%	10%
OPBDITA	11.62	9.76	5.14	5.53	5.25
Profit after Tax (PAT)	5.65	4.33	0.63	1.12	1.90
Net Cash Accruals (NCA)	8.26	7.48	5.22	4.42	4.10
OPBDITA/OI (%)	17.26%	15.72%	9.58%	10.11%	8.75%
PAT/OI (%)	8.39%	6.99%	1.17%	2.04%	3.17%
ROCE (%)	16.45%	12.30%	1.79%	3.56%	4.55%
Capitalisation & Coverage Indicators					
Short-term Debt	4.64	5.37	2.96	0.00	5.41
Long-term Debt	0.78	0.17	0.00	0.00	0.00
Total Debt	5.42	5.54	2.96	0.00	5.41
Tangible Net Worth (TNW)	47.04	50.69	53.96	54.32	55.47
Total Debt/TNW	0.12	0.11	0.05	0.00	0.00
Total Debt/OPBDITA	0.47	0.57	0.58	0.00	1.03
Interest Coverage	13.67	13.08	7.01	16.77	9.92
TOL/TNW	0.35	0.43	0.32	0.31	0.34
NCA /TD (%)	152.5%	134.9%	176.1%	-	75.8%
DSCR (excl STD/prepayments)	3.95	6.92	6.59	16.66	10.15
Working Capital Indicators					
Debtor Days	117	138	183	218	205
Creditor Days	71	123	146	181	132
Inventory Days	39	70	66	67	34
NWC/OI (%)	35.28%	37.51%	48.94%	49.13%	45.70%
Cash Flow Analysis					
Fund Flows from Operations	8.41	7.33	4.40	4.35	3.93
Retained Cash Flows	3.94	8.06	1.20	3.76	3.56
Free Cash Flows	0.90	5.53	0.71	3.03	-5.01

OPBDITA: Operating Profit before Depreciation, Interest, Taxes and Amortisation; PBIT: Profit before Interest and Taxes; DTL: Deferred Tax Liability; CWIP: Capital Work-in-Progress; NCA: Net Cash Accruals; TOL: Total Outside Liabilities; DSCR: Debt Service Coverage Ratio; NWC: Net Working Capital
Source: Financial statements of NCL

Annexure II: Details of Rated Facility

EXHIBIT 3: Details of NCL's Bank Limits Rated on Long-term Scale

Instrument	Amount (Rs. crore)	Rating
Cash Credit	6.50	[ICRA]BBB (Stable)
Total	**6.50**	

EXHIBIT 4: Details of NCL's Bank Limits Rated on Short-term Scale

Instrument	Amount (Rs. crore)	Rating
Bank Guarantee	1.29	[ICRA]A3+
Total	**1.29**	

EXHIBIT 5: Details of NCL's Bank Limits Rated on Long-term Scale /Short-term Scale

Instrument	Amount (Rs. crore)	Rating
Unallocated	4.70	[ICRA]BBB (Stable)/A3+
Total	**4.70**	

Links to Applicable Criteria:

Corporate Credit Rating Methodology

Rating Methodology for Entities in the Pharmaceutical Industry

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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.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

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