"Alkem Laboratories
Q3 FY2019 Earnings Conference Call"

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Moderator: Good day ladies and gentlemen, and welcome to the Alkem Laboratories Q3 FY2019 earnings conference call hosted by Motilal Oswal Financial Services Limited. As a reminder all participant lines will be in the listen-only mode and there will be an opportunity for you to ask questions after the presentation concludes. Should you need assistance during this conference call, please signal an operator by pressing "*" then "0" on your touchtone phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Tushar Manudhane from Motilal Oswal Securities. Thank you and over to you Sir!

Tushar Manudhane: Thank you. Good evening everyone. Welcome for this call. From Alkem management side, we have Mr. Sandeep Singh, Managing Director; Mr. Rajesh Dubey, Chief Financial Officer; Mr. Amit Ghare, President, International Business; and Mr. Gagan Borana, General Manager, Investor Relations. Over to you, Gagan!

Gagan Borana: Thank you, Tushar. Good afternoon, everybody and thank you for taking your time and joining us for Alkem Laboratories' Q3 FY2019 Earnings Call. I am Gagan from the Alkem IR team. Earlier during the day, we have released our financial results, and the same are also posted on our website.

Today in this call, we have the senior management team of Alkem to discuss the business performance and outlook going forward. Before I proceed with this call, I would like to remind everybody that this call is being recorded and the call transcript will also be made available on our website. I would also like to add that today's discussions may include forward-looking statements, and the same must be viewed in conjunction with the risks that our business faces. After the end of this call, if any of the queries remain unanswered, please feel free to get in touch with me.

With this, I would like to hand over the call to Mr. Sandeep Singh, to present the key highlights of the quarter and strategy going forward. Over to you Sir!

Sandeep Singh: Thank you, Gagan. Good evening, everyone, thank you for taking time out for our conference call. I hope all of you would have got some time to go through it. We have also put out a detailed press release and the presentation with the key highlights of the quarter and for the 9 months gone by.

I will briefly touch upon some of these key highlights, and would then leave their floor open for questions and answers. For Q3, FY2019, it has been a mixed quarter for the company. While our international business mainly led by the U.S. continued with its strong momentum, of around 40% year-on-year growth for the quarter, our India business faced challenge on account of FDC ban on select products, a relatively weak anti-infective season, the degrowth in our trade generic business, due to tightening credit terms set by us. Apart from this, high base of last year due to post-GST inventory normalization also impacted the growth in India business during the quarter.

Year-on-year dip in our gross margins for the quarter was mainly on account of high API prices that are prevalent because of supply issues from China and higher contribution from our international business, in which we have relatively lower margins. However, off late, we can see some early trends of moderation in the API prices. And if the trend stays, we can expect some benefits flowing through in the coming quarters.

Talking a bit more about the India business, as you can see from the IMS data, market growth during the quarter slowed down in both our key therapy segments of anti-infectives and gastrointestinal. These 2 therapies constitute more than half of our India business. Also about 3% of our India growth during the quarter was impacted by the ban on select FDC products, which we would look to mitigate over the medium-term through alternate products and launching new formulations that are approved by the regulator. We also tightened our credit terms in our trade generic business that led to lower offtake during the quarter and 9 months also. However, on the positive side, our chronic business continues to grow significantly ahead of the market growth rate, leading to improvements in our market share and market ranking in therapy segments of neuro and CNS, antidiabetics and even cardiac and dermatology. Moving to international business. I am pleased to share that our U.S. business delivered yet another strong quarter with growth of 44% year-on-year in quarter 3, and 47% year-on-year in the 9 months of the financial year. While there was some help from the depreciating Rupee versus the U.S. dollar, but the large part of the growth came on the back of a new product launches, and scale-up of the existing products.

During the 9 months of the financial year, we invested about Rs.323 Crores, in R&D, which is 27% higher than what we have spent in the corresponding period last year. We filed 14 ANDAs in the first 9 months and received 10 approvals, which included 3 tentative approvals. We now have a fairly decent product portfolio of 120 ANDAs already filed with the USFDA with over half of them yet to be commercialized. Timely new product approvals and commercialization would be a key driver of growth going forward in the U.S. market. And with no pending observations at our key USFDA approved facilities of Daman and Baddi, from where we have filed most of our ANDAs, we expect a steady flow of new product launches going forward.

Apart from the U.S., amongst the other key international markets, Australia and Chile also registered robust growth during the quarter, both in local currency as well as Indian rupees.

Coming to updates on the U.S. FDA inspection of our facilities, last month Daman and St. Louis formulation facilities underwent an inspection by USFDA. At the end of the inspection, no Form 483 was issued for Daman facility, while the St. Louis facility received 8 observations. We are now in the process of replying to the USFDA with comprehensive corrective and preventive action plan within the stipulated timeline. We remain committed towards quality and compliance. Summing up the performance of the quarter and the 9 months gone by, I would like to say that it has been a mixed performance with robust growth in the international business, and lower than expected growth in our India business. However, I am confident that the significant investments that we have made in our infrastructure, and in our people over the last couple of years, will deliver good results in the quarters to come.

With this, I would like to open the floor for questions and answers. Thank you.

Moderator: Thank you very much Sir! Ladies and gentleman, we will now begin with the question and answer session. We have the first question from the line of Saion Mukherjee from Nomura. Please go ahead.

Saion Mukherjee: Just wanted to check on the -- what's happening on the trade generics business. You mentioned some credit you have tightened there. So if you can explain what's really happening? Is it the first quarter you have started this? And how we should think about this business going forward?

Sandeep Singh: Yes. Hi. So Saion last year, we were pretty aggressive on the trade generic part. So as you know, trade generic operates on very different parameters than prescription drugs. So there was a very aggressive stand last year. So we had given some credit terms, which were more than the norm last year. So this year, we have got it back, normalized it, and some extent tightened it further. So therefore there has been some degrowth. So this is not the first quarter to answer you, we have started doing this from the beginning of the year itself. Since you know it is a fairly large sort of a domestic business, so therefore, it has overall impacted our growth as well.

Saion Mukherjee: Okay. Sandeep, how big is it now in terms of overall percentage? And going forward, right, so this year there is a decline, and going forward, it will decline further, you think? Or it can grow from this pace?

Sandeep Singh: So look, now it is currently 15% to 20% of our domestic business, trade generic. Going forward, since this year, the correction has already happened. So from the next financial year, I do not see any reason for degrowth, and it will be back to its normal growth, what it has always been doing.

Saion Mukherjee: Okay. Thanks and just one more question on the U.S., so this year, you have seen, I think, one of the best years, right? I mean, in terms of the growth in the U.S. You mentioned about new launches as well as older products. Like if you were to split it up, and talk about, whatever it was, \$70 million, \$80 million incremental revenues, how would you think it can be split between new launches and older products?

Amit Ghare: Hi, Saion. Amit here. I think it has been fairly even from both perspectives. Obviously, the new launches haven't contributed 50%, they have been little less than 50% in terms of growth, but any contribution coming from new product is a pure growth, as you understand, that is what the new product is. So overall, it has been a handsome gain from both the areas.

Saion Mukherjee: Thanks and any comments on pricing environment you want to share in the U.S.?

Amit Ghare: So the deflation has been witnessed across the quarters and years, continues to remain the same. There's no alarming increase, nor is there any huge decrease in it for that matter.

Moderator: Thank you. The next question is from the line of Aditya Khemka from DSP Mutual Fund. Please go ahead.

Aditya Khemka: Sandeep, on the India business as you said, last year, we went aggressive on the trade generic business, and this year, we have tightened some credit terms. I mean, what was the necessity, or what caused you to take that measure?

Sandeep Singh: You mean tightening it, right? You mean?

Aditya Khemka: Yes. Yes.

Sandeep Singh: So it is the working capital collection because, obviously, doing [sale is easy] but doesn't amount too much if you do not get your collections on time. So that was one of the reasons. Second is, obviously, you do not want your trade generic component to become a much larger thing than what you actually want.

Aditya Khemka: Okay, I get it. And anything on the trade generic side? On the regulatory front you are hearing. I think we had some time back the government was trying to tighten the regulatory nozzles from the trade generic business. Anything, any new development there? Or anything you feel the government is trying to do in that front?

Sandeep Singh: No. I have also heard that same things which you all have heard. So nothing new development. So just to build on your question further, even if there is some regulation, I think we being one of the largest companies there, we continue to have a competitive advantage. And last but not the least, so if generics come down, overall trade generics, it would flow to prescription generics. And we will be equally happy or are more happy if that happens. So that way we are pretty balanced out.

Aditya Khemka: Sorry one more added question to the same part. Trade generics will generally have lower gross margins, but similar to the margins to branded generics. Is that a fair?

Sandeep Singh: No. It is a decent business on its own. On the subscription side, once you get scale, the return on capital is far better than what you would think. So branded business continues to be really a good business in all parameters.

Aditya Khemka: Okay. Point taken, Sir. And secondly, on the India business front, I mean most companies have been saying this has been a poor season from the prescription generics prospectus, especially anti-infectives. And the growth rate sort of is affecting the whole season. I just wanted to understand this poor season a little bit more. Do you think the poor seasonality is purely based on weather conditions? Or do you think it is more linked to some structural factors like more hygiene, more sanitary facilities available within the country? What is this poor season really an effect of?

Sandeep Singh: So I think, it is got to do more with vagaries of nature. On the second part of whether the swatch Bharat is working and people are more hygienic. I think that is also working, but it is not that much. It is still the former part, which is at play over here.

Aditya Khemka: Fair enough. And also within this again, on the anti-infective part, are you seeing more aggressive competition from these smaller players out of the top 50 within the country? Or do you think within that segment, you are still gaining market share?

Sandeep Singh: I think on the question of smaller players, I think, that is playing out for everyone and in all therapy areas, not just anti-infectives. So nothing in particular for anti-infectives, but yes, smaller players, new players are coming in, they are doing well. It continues to be that same cycle, which happens in Pharma.

Aditya Khemka: Okay, so they are gaining market share basically across therapies?

Sandeep Singh: Yes.

Aditya Khemka: Okay, okay, and on the US business, Amit, mycophenolate, we were originally contemplating some lifecycle management strategy. Where we are in that strategy? And how close to fruition is it?

Amit Ghare: I am sorry. I did not get the question, Aditya.

Aditya Khemka: Yes, so on mycophenolate suspension, we were originally talking about some product lifecycle management strategy. I just want to know the status of it and how close to fruition are we on that?

Amit Ghare: I do not think we ever spoke on lifecycle management for mycophenolate, Aditya. After all, we are generic and we continue to have healthy market share, and we continue to be exclusive. I think, that is what we have discussed. We want to discuss whether we are going to witness competition in days to come. For which, as we have already advised, we do not really see that until someone gets approved. So from that perspective, I guess, that is where we stand.

Aditya Khemka: But this is a product that requires a clinical trial if I am not mistaken? A whole list of clinical trials, so do you have any sense of anybody conducting or having finished the clinical trial?

Amit Ghare: It does not require a clinical trial as a generic, Aditya. It requires a bio clinical study. And the guidelines are clear on the FDA website.

Aditya Khemka: Okay, fair enough. Lastly, on this API, the gross margin declined that you saw this quarter. I understand the API price inflation has been the major issue. But has it been more of an issue towards the India business side? Or has it been issue on the U.S. business side?

Rajesh Dubey: API price increase, it has affected both the business, so it is not India or international. API prices, it has impacted at both the places. A little bit more or less, but impacted.

Aditya Khemka: Okay. So what is the mitigation strategy there, Rajesh? Sir, if you may on the API side. So prices may have flattened but they are not declining, as I understand it correctly. So is this the new normal gross margin for us because if we continue to take products at the same prices, gross margins are not going to improve. So we have only 2 options, either we pass on to the customers, which does not seem viable in U.S., and is it viable in India, Sandeep?

Sandeep Singh: So on the mitigation front, see honestly, we see that China, things might get back to its normal situation. So that would happen, we guess, in the next few months. I do not think so I mean, any company for that matter would be able to mitigate China risk. Because do not forget not just the API but in n minus one and the intermediates, everybody is dependent on China. So that risk remains so there is no mitigation outsides for that. Second part is passing on price, right? So Amit can answer on the U.S. part, but on the India side, we all know that it is not easy to pass on the price hike. You are capped by 10% even for non-DPCO. And of course, in DPCO you cannot, you have to do by inflation index. So there you cannot pass on. I mean, which you all know. So but you know, I do not think, Aditya, this price hike would stay in very long, and if it really starts happening then you see a lot of India companies, not companies like Alkem, but companies who are API focused and with the help of government, they will try to do something. But that would play out in a couple of years' time; it cannot be done so fast. Amit, would you like to just pass a comment on U.S.?

Amit Ghare: No I think, it is known. Wherever we have opportunities to pass on, we will pass on. Wherever can build efficiencies, focus on back end and optimize, we will certainly do that. And as you rightly said, while it has plateaued right now, that is the first sign. It will correct also going forward. So that is the hope and expectation.

Aditya Khemka: Okay, 1 more if I may. I am sorry for the enormity of questions. On the R&D budget, so R&D went up 27% Y-o-Y. So 2 questions into that. What is the total R&D budget for FY 2019, and 2020? And secondly, are you filing more ANDAs because of the rise in R&D spend?

Sandeep Singh: Sorry, your last question, I did not get you, Aditya.

Aditya Khemka: Are we filing more ANDAs because of the increase in R&D spend? Is that because you are trying to file more ANDAs in the U.S.?

Sandeep Singh: This year we have filed more ANDAs than what we have done last year, no doubt about that. R&D budget is 6% of our revenue.

Aditya Khemka: Thank you.

Moderator: Thank you. The next question is from the line of Rashmi Sancheti from Anand Rathi. Please go ahead.

Rashmi Sancheti: Just want to know that how much percent of your domestic portfolio comes under the FDC ban?

Sandeep Singh: It is around 3%.

Rashmi Sancheti: 3%. And Sir, so your whatever dip in the gross margins, is it majorly because of high API prices? Or is there any other adverse product?

Sandeep Singh: Sorry, Madam. It is a mix of APIs going up and international business contributed a lot more than usual. So this quarter if you see, it garnered nearly 35% of our revenue. And the gross margins in international business are lesser. So I think, it is a combination of these 2.

Rashmi Sancheti: Can you just quantify whatever dip in during the 9 months we have around 200 to 230 basis points dip in the gross margins? Can you quantify how much was business prices only due to the high APA prices?

Rajesh Dubey: And see the qualification in gross margin, I think that information is already available. But mainly it is on the account of API prices. Of course, quarter 3 got impacted due to sales mix on the international than on our side. But it is merely on account of API prices.

Rashmi Sancheti: And Sir, can you give the capex guidance for the next 2 years.

Rajesh Dubey: This year, most probably, it will be in the range of Rs.550 Crores as it was discussed last time. And for next year, we believe, we will be close to Rs. 400 Crores.

Rashmi Sancheti: Rs. 400 Crores for FY2020.

Rajesh Dubey: Yes. 2019-2020, yes.

Rashmi Sancheti: And lastly, on the St. Louis facility if you could talk or anything in detail about the observations, the 8 observations which you have received, whether those are very critical in nature, or procedural in nature, or anything on that part?

Sandeep Singh: Sure, ma'am. So as you know FDA doesn't classify observations on critical or major like the European or U.K. MHRA, however, we feel that these are addressable. These are more procedural in nature. We do not think it will turn out to be a lot more serious than what it is, however, we do not take it lightly. We look at it in all seriousness. I think with this, I will leave it at that. We will have to reply, and but we think we can overcome this. I do not think it is out of our control.

Rashmi Sancheti: Thank you.

Moderator: Thank you. The next question is from the line of Neha Manpuria from JPMorgan. Please go ahead.

Neha Manpuria: Sir, just to understand on the domestic business. One, what are the growth drivers of the trade generic business? Because you have said that you had been very aggressive in terms of sort of lax credit terms. How are we sure that, that growth would go back to normal as we tightened the credit terms? And second is on the anti-infective business. Was there any destocking, et cetera, that we saw that impacted our GI and anti-infective business particularly?

Sandeep Singh: Yet, so on the trade generic part, Neha, you asked us what is the growth driver, and what drives that business. So see, Alkem is pretty well konwned. So your stockist and everyone, they know us so. Can any other company come and give the same terms and prices and get that market share? The question is no. So we have the brand name we have the distribution channel, we have the depth. So we could do a good job there. And you asked what gives us confidence that once we tightened the credit limit and we can still maintain growth see, please do not forget that we have built the large business, and it is not just built on giving credit days, the whole business that you have built. That was an anomaly last year, somewhat. So that degrowth will only be this year, which we have seen. So going forward to next year when this correction has happened, we will go back to a normal growth rate. So you know, this business has built over the years. Obviously we were not giving such credit terms as we gave last year always. So we feel very confident that we will be back to normal.

Neha Manpuria: So the contribution of this business is always been in the range of 15% to 20%? It is not as if it has grown significantly during this period where you have given...

Sandeep Singh: Significantly in the last 3 years, we have been around about that.

Neha Manpuria: Okay, understood. And what is the normalized growth rate? Is it in line with the company's growth rate? Or does the -- is this business growing faster?

Sandeep Singh: You mean to say off trade generics?

Neha Manpuria: Yes.

Sandeep Singh: It is slightly lesser than the domestic business, this year, obviously.

Neha Manpuria: No, no. Usually when you say normalized, historically has this business grown higher than our average...

Sandeep Singh: It has grown higher than our normal domestic business, I mean -- yes, domestic business.

Neha Manpuria: And that is a fair assumption, even as we look at growth for the next 2 to 3 years?

Sandeep Singh: No. I will not so, that it will be a fair assumption. The growth rate might not be higher than what our domestic business would be.

Neha Manpuria: Okay. And my second question Sir, was on the anti-infective and GI. Was there some destocking which impacted growth and therefore that could come back as inventories normalize? Because we heard a few of your peers indicating that.

Sandeep Singh: So to be honest, we do not see that destocking was a major enough factor for the growth coming down. But nevertheless, we have grown in line with the industry or slightly more even in these segments. And in my commentary, I had mentioned that anti-infective and GI have both kind of slowed down in the last quarter.

Neha Manpuria: So there's no specific destocking that we have seen?

Sandeep Singh: No.

Neha Manpuria: Okay, understood. And one other question on the U.S. business. You have indicated in the past that we will have probably high single-digit launches, given that the approval run rate is closer to 10, Should we expect pickup in launches? I know, some of them are tentative approvals, but as we are filing more products probably approvals will pick up. So should we see an improvement in the launch run rate in the U.S.?

Amit Ghare: Yes, Neha. So that is a fair assumption. We already have a more approvals in 9 months than what we had last year. And more launches as well. So by the time we close the year, our number of new launches certainly will be on the higher side.

Neha Manpuria: And going forward, Sir, what sort of launch momentum should we look, given we are filing more products?

Amit Ghare: So to an extent to higher approvals here a result of 2 things. One is the backlog getting cleared and FDA obviously, approving faster. And also, our filings have gone up last year also and this year also they have gone up. But I think, our overall guidance that we have always given of 12 to 15 filings in a year that is what we continue to target. So the approvals will also be between 10 and 12 every year, and launches, higher single-digit every year.

Neha Manpuria: So launches we are still seeing high single digits?

Amit Ghare: Yes, I am talking about, let us say, a 3-year, 5-year horizon and taking an average.

Neha Manpuria: And how many have you launched for 9 months this year?

Amit Ghare: I do not have a specific number clearly in front of me right now, Neha.

Moderator: Thank you. The next question is from the line of Sayantan Maji from Credit Suisse. Please go ahead.

Anubhav: This is Anubhav here. One question on the trade generic business. When you mention about credit terms, just as an idea, what were these terms last year versus now? For example, receivable days last were they like more than a month? What is it now? Some idea will be helpful.

Sandeep Singh: I do not think we ought to disclose those terms.

Anubhav: I am just been trying to understand like, let us think of a number. Last year, it was like just an example, 2 months, now it is like a month. So now when you have reduced it, is it that the trade partner, let us say the chemist makes much more margins selling someone else, for us that we would have seen a decline?

Sandeep Singh: No, the trade why will the margins change? You are talking credit days?

Anubhav: I am saying for him there was an incentive that was driven by Alkem, why we were seeing very high number, which was in credit terms, maybe not in terms of margins. You are not earning margins now, but if the partner is not picking our product, of course, he is selling someone else's products.

Sandeep Singh: That choice he always has. And we are very happy for him to pick somebody else who gives him larger credit days. That is okay.

Anubhav: So the choice is more on the credit days rather than the margins, is it? And that is how it is a bigger driver.

Sandeep Singh: It is a combination of both. So business it is not evaporating, right. It stays. It is only not growing as much as it grew last year when we gave those credit days.

Anubhav: Okay. And in this process, have you also limited to some of the, let us say, trade partners that you work with? Or is it largely just a reduction of credit days?

Sandeep Singh: I do not think so we have reduced the trade partners or kind of banned some of them. I do not think so. It is basically tightening.

Anubhav: Okay, the second associated question was on gross margin. So when I do the gross margin mix, I completely agree with your logic that international's proportion is higher therefore the gross margins are lower in this quarter. But within India margins also, there's a clear dip in the gross margins, only for the India divisions in this quarter. Now just trying to check, is that all related to the higher API? And I am comparing only sequentially Q2 to Q3 just on the gross margin. Is it just because the API prices in China has gone up higher in this quarter? Because I was assuming that if our trade mix, which should be lower margin, is lower this quarter, the margin should be higher actually gross margin.

Rajesh Dubey: Yes, my sense is you are right to this extent. As far as the India margin is concerned. Margin decline is mainly on account of increase of API prices. More or less, that is only visible factor affecting gross margin.

Anubhav: Thank you.

Moderator: Thank you. The next question is from the line of Saion Mukherjee from Nomura. Please go ahead.

Saion Mukherjee: Thanks for the followup. Sandeep, I am just wondering on the domestic business. Over the years, there seems to be changes happening; chronic is growing on the one hand, on the other hand, you have FTC ban, price control and now API prices going up. Overall profitability in terms of EBITDA margin for the domestic business, how is the trend you see internally? Is it improving? Or it is kind of declined? Any color you could give on that on this business?

Sandeep Singh: It is not as productive, because see we have mentioned some time back, I do not know in which call, see this year we have added close to 1000 reps, on the ground medical reps. So we have been saying that we have been ahead of the curve to get a higher market share, be aggressive. So it is improving very slightly, but chronic business is outgrowing. So the next couple of years, we will see a much better improvement on operating margins for the domestic front as well.

Saion Mukherjee: EBITDA margins for domestic business would be more than 20% as a benchmark? I mean most companies indicate that it is more than 20%.

Sandeep Singh: Yes. Sure.

Saion Mukherjee: Okay. And just a question on pricing environment, Sandeep. I mean, you mentioned about difficulty in passing on prices in India. And now typically your companies, which have strong brand, are able to do that. Is it because many of your brands are under price control that you are not able to do it? Because I would assume, the brand strength should help you kind of pass on price increases because...

Sandeep Singh: But Saion, as you know, pricing you can increase only once in a year, 10% maximum. So it depends on when it is getting due and whether we can. And if it is in DPCO, then we cannot. And we have around 30% of our revenue, of our domestic is under DPCO. So wherever we can, we will, to what extent we can. But I do not think so we can completely do that.

Saion Mukherjee: Okay. And just on API price, Sir. How much is the increase because of the China situation. It can quantify year-on-year, how much is the average increase that you are seeing raw material prices?

Rajesh Dubey: Saion, we do not have any ready figure that impact of China on our API price. But I think, even though, if we are buying from domestic suppliers, the API is getting impacted because of China issue. As a percentage, it is a mixed kind of we do not have any concrete percentage what kind of increase is affirmed. Because on API it is changing from material to material, but yes, increase has happened more or less all across. It has started, I think, let us see how it is reacting going forward.

Saion Mukherjee: Actually I was looking at your level, the procurement that you are doing. On an average, if you can share like how much is the increases? Is there a number that you can share on average?

Rajesh Dubey: We do not have a ready number right now, what percentage on API cost China has impacted, because in most of the cases, our majority of our procurement is from domestic suppliers.

Saion Mukherjee: I mean, you would be procuring from them, but they would have increased the prices, right if you factor in?

Rajesh Dubey: We have not worked on that.

Sandeep Singh: I think Gagan can back to you later on.

Saion Mukherjee: No problem. And then just one last question on U.S. profitability. How is it looking even the scale-up, which we have seen in the business? How is the profitability looking for the U.S. business now?

Amit Ghare: Yes, Saion. It continues to perform better at, I think that is something that I can track it and confirm. So we are better off today than what we were yesterday from a margin and profit perspective.

Saion Mukherjee: I mean, it is positive EBITDA now?

Amit Ghare: Yes, it is.

Saion Mukherjee: And after considering the R&D expenses?

Amit Ghare: Yes, absolutely.

Saion Mukherjee: Thank you.

Moderator: Thank you. Next question is from the line of Abdul Puranwala from B&K Securities. Please go ahead.

Abdul Puranwala: Okay, just one question on the inspection front at the St. Louis. So we have had FDA inspection 6 months ago as well. When we had cleared the inspection and then we again have these 8 observations. So may I know what was the reason why the FDA had to visit our plant again?

Sandeep Singh: I think, sometimes a preapproval before granting approval to an ANDA, they are common. So this was with respect to that.

Abdul Puranwala: Okay. So the observations are largely related to the plant or some particular product?

Sandeep Singh: Largely, plant.

Moderator: Thank you. The next question is from the line of Aditya Khemka from DSP Mutual Fund. Please go ahead.

Aditya Khemka: Amit, of which product was this pre-approval inspection for?

Amit Ghare: I cannot name that, Aditya.

Aditya Khemka: Okay, is that like a large ticket limited competition product? Or is it around the middle products with some manufacturing difficulty?

Amit Ghare: Well it certainly has its own niche because we are manufacturing it in the U.S. so obviously, you understand that part.

Aditya Khemka: Got it. Okay, secondly, on the gross margin. And sorry to harp on this, but just bear with me for a minute while I explain my confusion. So your USD, your business in U.S. has seen USD appreciation, and again inflation, obviously, would have come in the raw material cost. But in my opinion, or in your assessment, fair to assume that the USD gross margins, the U.S. business gross margins, would have actually expanded or stayed stagnant but not fallen. Is that a fair assessment?

Amit Ghare: So the question earlier was asked in absolute terms, and my answer was more from absolute terms, rather than from percentage terms. On percentage terms, if the question is from your side, I would say that overall impact they would have slightly fallen.

Aditya Khemka: This is the gross margin in percentage terms for U.S.?

Amit Ghare: That is correct.

Aditya Khemka: Slightly fallen despite the USD appreciation?

Amit Ghare: In percentage terms, yes.

Aditya Khemka: Yes, in percentage terms, okay. And on the India business the same problem. So your chronic business is growing faster, your trade generic is slowing down, which has lower gross margin. Chronic has higher gross margin growing faster, and despite that the kind of decline. So my confusion is that your cost of goods, cost of raw material would be about 40% of your sales, right? And in that 40%, I assume, API prices or the API component would be 4% or 5% of sales. And if that, even if it seems like a 50% inflation, you are it 2% of sales or so. And API inflation is not across APIs, right? It is in certain APIs. So I mean it would be worthwhile, or would you reconfirm that all of it is just API? Sounds very improbable to me, the math is slightly difficult to do.

Sandeep Singh: I think most them is API, Aditya. And you said 4% to 5% of our sales is API. I think that number is wrong. It is obviously much higher.

Aditya Khemka: It is higher, okay.

Sandeep Singh: It is much higher and that is from everyone I guess Aditya. But this is something more we can talk about it later. So the second part, see, it is also in the product mix. So please do not forget, unlike other companies, our portfolio is very antibiotic and antibiotics, which is made from GCFC and P&G all which India does not make. If China would impact us, or it has impacted us more than, let us say, our listed peers would. So that is one part. I would like to draw attention yes thank you.

Aditya Khemka: Thank you, Sir. Just a last question, Sandeep, anyway for you. So India business saw disruption in FY '17, saw disruption in 2018, 2019 has thrown it is challenges in terms of anti-infective season not being good and our trade generic rationalization, FDC ban. What is the outlook for FY2020 in your view? Should we expect growth to go back towards 13%, 14% range? Or do you think it can be better than, lower than that? And I am talking about the entire India business, which includes your trade generics and your chronic and acute?

Sandeep Singh: Holistically, yes. So you know, we have always maintained that we aspire to and we have, we will outperform the industry by 200 basis points. I think I maintain that, because if you see IMS numbers on the prescription side, we grew by 14% for the 9 months. And so going ahead, it would be the same. This year, the trade generic impact was there. And next, we are also kind of growing the chronic business and every year might not have a dull season. I think it is fair that we would expect to get back to what numbers we are going to what you just discussed close to say 12%, 13%. I think that is very realistic, and we are gunning for that.

Aditya Khemka: Right and for your portfolio, which is under NLEM, do you generally, take the full extent of WTI price increase?

Sandeep Singh: Yes, we generally do.

Aditya Khemka: And for the non-NLEM portfolio, I know it depends upon competitive landscape, et cetera, but where you have stronger brands, why would not you take a 10% increase?

Sandeep Singh: No, so it depends on where you are going that. But so I will say that, we would take almost a full part of it and most of the time, but there are exceptions where we leave it.

Aditya Khemka: Understood. Okay, and lastly, on the cash flow side Sandeep. So our balance sheet is strong, we have a net cash balance and we continue to invest cash in the way I look at your financial statements. What is the utilization going to be? I understand you pay dividends once in a while, but we still see cash pileup on the balance sheet. So how would you utilize that cash? Or is this inorganic strategy or buyback? Or dividends would be the way to use it?

Sandeep Singh: So Aditya, first things see I do not think we have plenty. I do not think we have too much cash lying down and we do not know what to do with it. So I think we are still away we pile up some cash and it becomes a genuine concern. So I think, we are 3 to 4 years away where you will have a lot of cash and obviously we can talk on that. So as of now, we do not have net cash. I think you know that, Aditya. Point number 1. Second, we do not have any large acquisition plans or even medium-sized. I think we are in the right segments, we need to focus, grow those businesses. Historically, we have grown business organically especially in India. I mean, you have to appreciate the fact we are number 6, number 5, whatever we are without acquisition. And we think we can continue to grow. U.S. we have invested, so there again, we do not want to buy anything right now. And yes, dividends you said, once in a year we pay dividend, but I think we do it consistently and we always have. We maintain that we will declare our 25% of our net income every year. When there is too much cash and it is a great problem to have, then we can have this conversation.

Aditya Khemka: Fair enough, Sir. I hope you do one day. Rajesh, I thought you mentioned capex at Rs. 550 Crores and then Rs. 400 Crores. Where do you see capex going exactly?

Rajesh Dubey: Sorry I did not get you.

Aditya Khemka: Your capex plan, so where you are utilizing that money? What capacity are we adding? Where are we using that capex?

Rajesh Dubey: Mostly in facilities, Aditya. See when I am talking Rs.400 Crores, some leftovers of current facility, what we are having in our hand as well as our routine capacity. See our Indore facility is going on, even though all is for investment taken this year, but they are on cash flow it has to have some carry forward. And like in at other places also, as well as our maintenance capex, all put together Rs. 400 Crores.

Aditya Khemka: How much is the maintenance capex, Rajesh, Sir?

Rajesh Dubey: Considering our facilities, it is a sizable amount. So when I give Rs. 400 Crores, you can say around 50% for modernization or replacement or routine capex and the remaining half of the portion for our carry forwards.

Aditya Khemka: Thank you.

Moderator: Thank you. The next question is from the line of Neha Manpuria from JPMorgan. Please go ahead.

Neha Manpuria: Sir, if I look at the number that you talked about for India growth going back to about 12%, 13% and the fact that the U.S. has achieved positive EBITDA. As the growth momentum improves further, our profitability should be significantly higher than what we have done in the last 2 years, which is around at 15%, 16%. Can I know in the past you have mentioned 1 percentage points increase at least every year? But is this quote for that probably much higher, given U.S. is now positive and, and growing higher than what we had expected?

Sandeep Singh: So, Neha, honestly, we hesitate and we do not want to actually give guidance. I think that is very prudent, looking at the business development. So do not forget, that Amit also mentioned, when Aditya had probed him, U.S. business grows, but in absolute profit margin percentage, there is some pressure even now. So cannot be very sure that you will have a significant increase. Yes, there would be some increase in EBITDA margins, but I would not just like to guide or give hope too much for it for next year.

Neha Manpuria: Yes, but Sir given this year was particularly impacted because of India business and API, as API costs are plateauing, and India growth comes back. From the current pace, should not the EBITDA margins be significantly better?

Sandeep Singh: The question is when, next year if you want to know.

Neha Manpuria: Yes I mean in next year, ideally next year, but yes. Is not that understanding correct? I mean what additionally would we be spending that would sort of not allow us to expand margins as much?

Sandeep Singh: As Mr. Dubey said, there is Indore facility which we are expanding our existing plants also. So they are taking manpower, it takes some time for the plants to hit 50% capacity, or any benchmark where you start kind of making money on that section. So there will be some investment, there will be additional manpower, and do not forget, we might also add some manpower even next year in the field force front. So I would not say that we should be completely gung ho and dead sure that they will be an EBITDA margin increase significantly next year.

Moderator: Thank you. The Next question is from the line of Saion Mukherjee from Namura. Please go ahead.

Saion Mukherjee: Just taking the point forward on margins, Sandeep. I mean, I understand that you are doing some expansion in addition. What is the expectation on margins at a steady state basis? Because you are saying India margin is more than 20%. I mean, U.S. should increase the margin as it scales up, right? If you see through the next 2, 3 years of what is the kind of margin that you are targeting?

Sandeep Singh: I mentioned that I do not want to give any forward-looking, I mean any guidance. But since you are forcing me and you are doing a good job, I would say, we can aim to, let us say, in the next 2 years, maybe 18%, 18.5% we aspire to be, not next year. Let's say in a couple of year’s time.

Saion Mukherjee: Okay. But is that not or do you think what is conservative or I mean that would be the lower end of what your peers are doing, right?

Sandeep Singh: You know that is true. But every company is different. Also do not forget, Saion, if we want to pick up some big ticket R&D, if you want to get into some complex things, then we want that flexibility. So I will not over commit and say that we will hit 20%.

Saion Mukherjee: Okay, on that point on R&D, have you decided given the current landscape, any thing you can share that you are working on in terms of your product portfolio in the U.S.?

Sandeep Singh: So you know we have mentioned that we are working on, we have nasal sprays and transdermals, but it is a little premature right now. At the right time, I will surely again talk about complex things what we are planning.

Saion Mukherjee: Okay, and just one last question, housekeeping. You had a weak Q1 because of distribution policy, right? So this time in the fourth quarter, whatever the gap, I think Rs. 200-odd Crores was there, that would be made up. So you won't see a major dip, right? In portfolio.

Sandeep Singh: 100%. Yes, absolutely.

Moderator: Thank you. As there are no further questions from the participants, I now hand the conference over to the management for their closing comments.

Gagan Borana: Thanks you again for attending this call. If any of your queries have remained unanswered, please feel free to get in touch with me.

Moderator: Thank you very much, members of the management. Ladies and gentlemen, on behalf of Motilal Oswal Financial Services Limited, that concludes this conference. Thank you for joining us, and you may now disconnect your lines.