"Neuland Laboratories Limited Q3 FY-17 Earnings Conference Call"

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Moderator: Ladies and gentlemen good day and welcome to the Q3 FY17 Earnings Conference Call of Neuland Laboratories 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 the conference call, please signal an operator by pressing '*' and then '0' on your touchtone telephone. Please note that this conference is being recorded. I would now like to hand the conference over to Mr. Diwakar Pingle from Christensen IR. Thank you and over to you sir.

Diwakar Pingle: Thank you Karuna, good evening to all of you, welcome and thanks for joining the Q3 FY17 earnings call of Neuland Laboratories. Please note that we have mailed out the press release and you can also view this on our website at www.neulandlabs.com.

To take us through the results of this quarter and answer your questions, we have with us the management represented by Mr. Sucheth Rao - Vice Chairman & CEO; Mr. Saharsh Rao - Joint Managing Director. We will be starting the call with a brief overview given by Saharsh providing a brief of the company's performance which will then be followed by the Q & A session. I would like to remind you that everything said on this call which reflects any outlook for the future or which can be constituted as a forward-looking statement, must be viewed in conjunction with the uncertainties and the risks that we face. These risks are unpredictable but not limited to what we have mentioned in our prospectus filed with SEBI and subsequent annual report which you can find on our website. With that said, I now turnover the call to Saharsh. Saharsh over to you.

Saharsh Rao: Thank you Diwakar. In addition to Sucheth and me, we also have Mr. Anil Kumar, our CFO, Mr. Kumar Gupta – our AVP (Finance) and Mrs. Sarada who is our Company Secretary. Good evening friends, a warm welcome to all of you joining this call. I would first like to touch upon the numbers for the nine months' period followed by the quarter's performance.

For the nine months' period the total operating income was Rs. 431.8 crores as compared to Rs. 374.9 crores representing an increase of 15%. EBITDA stood at Rs. 65.7 crores compared to Rs. 60.6 crores during the same period in the previous financial year, up by about 8%. EBITDA margins for these nine months stood at 15% in comparison with 16% for the same period last year. Net profit stood at Rs. 23.9 crores compared to Rs. 19.8 crores for the same period last year, representing an increase of about 21%. Basic EPS stood at Rs. 26.92 as against Rs. 22.27 representing an increase again of 21%. For the third quarter of this fiscal 2017, the total operating income was Rs. 132.4 crores compared to Rs. 123 crores compared to the Q3 of previous financial year. For the current fiscal quarter Q3, the total operating income was Rs. 132.4 crores compared to Rs. 123 crores in the corresponding period of the previous year representing an increase of about 7.6%. EBITDA stood at Rs. 15.5 crores compared to Rs. 19.4 crores of the quarter of the previous year. EBITDA margin was at 11.7% for this quarter as against 15.8% for Q3 of FY16. Net profit stood at Rs. 3.8 crores for this quarter compared to Rs. 6.3 crores in the corresponding period of the previous year and basic EPS stood at Rs. 4.30 as against Rs. 7.7 for the corresponding quarter of the last fiscal. Our performance in Q3 FY17 was below our expectations; one of the key reasons has been the spillover of our few shipments into subsequent quarter, the Q4. This apart, the flow of orders in this quarter was lower in comparison to the first two quarters of this financial year but again it is a little consistent with the trend which we have observed typically in some of the third quarters of the previous financial years. Despite these reasons, we expect to close the full year as per plan. Moreover, we believe that the overall outlook for the business in the long term remains very promising.

From an operational standpoint, we have scaled up three products for the GDS business this quarter; they include Aripiprazole, Apixaban and Ticagrelor. We have in addition scaled up four new products for CMS in our plants. From a project perspective, the company derived CMS revenues from 12 projects, this is in comparison with 8 projects which we derived revenues from in Q2 of FY17 the previous quarter and in comparison, 3 projects for the third quarter of the previous financial year. Out of these 12 projects that we derived revenues from, 9 are in commercial stage and 3 are in clinical stage.

The CMS business continues to see an increase momentum as we scale our products in the plant and add new projects. The contribution of the CMS business for this quarter was 25%, up from 16% for the same quarter last year. Now just talking about the merger process which was announced in the last investor call, the company has received observation letters from the stock exchanges conveying their no objection to file the draft scheme and is in the process of filing an application with The National Company Law Tribunal (NCLT), Hyderabad for seeking direction. So, it seems like the merger plan is on track and we are confident on completing the process as per schedule.

Overall, while the quarter was tepid on both revenue and margin counts, we are quite excited by the overall progress of the business and particularly the CMS business and are confident of the business playing out in the longer term.

With this, I would like to throw open the floor to Q & A.

Moderator: Thank you very much Sir. Ladies and gentlemen, we will now begin the question and answer session. First question is from the line of Rashmi Sancheti from Anand Rathi. Please go ahead.

Rashmi Sancheti: I just want to know how much worth order has been spilled over from third quarter to fourth quarter.

Saharsh Rao: Approximately about 6% to 8% of the overall sales.

Rashmi Sancheti: 6% to 8% of the quarter 3 sales, right; that is Rs. 1324 million?

Saharsh Rao: Correct.

Rashmi Sancheti: Sir, so on a quarterly basis we used to do run rate of around Rs. 43 crores in the niche segment, this time we have done, I mean we have shown a de-growth, so I assume that the order which has got spilled over was in niche segment only.

Saharsh Rao: Yes, that is correct actually, so we manufacture these two products call Entacapone and Salmeterol; both of which we categorize under niche or specialty API, so some of these shipments actually got spilled over into the next quarter.

Rashmi Sancheti: So then what I understand that you know if you are doing a quarterly run rate of say Rs. 40 crores to Rs. 45 crores in every quarter from the niche segment and the order which has just got spilled over in this quarter, so Rs. 43 crores plus the order which got spilled over will come in the fourth quarter.

Saharsh Rao: You could say that but the only caveat I would add to that is we do see a change in product mix every quarter, so it is not absolutely necessary that we will have the exact same run rate for niche or specialty API, so it will depend on the order that flow in, the customer that we are shipping to. So you will see kind of a variation from quarter to quarter.

Rashmi Sancheti: Okay, but what I want to understand is that it will be higher than the quarter 2 or quarter 1, the niche segment sales.

Saharsh Rao: It should be, but at the same time like I said it will change from quarter to quarter but that is the general trend.

Rashmi Sancheti: And what I want to understand that because of this spilled over only your margins have I mean it is just what you call lower than the previous two quarters. I mean we are doing in the range of 16.4%, 16.9% kind of operating margin but in this quarter we have just done 11.5%. So is it because of spillover of order or there are some other reasons also behind the lower operating margins?

Saharsh Rao: That is correct; it is mostly because of the spillover of order that is …

Sucheth Rao: It is largely because of the spill of order because if you see the cost structure for the first two quarters and the third quarter, they are almost in similar range, however because as Saharsh said, because we had a spillover of revenue and that is the reason why we had a slightly lower EBITDA and profitability.

Rashmi Sancheti: And quarter 4 again we can see the similar kind of operating margins, I mean coming back to the same 16%+ margin in quarter 4.

Saharsh Rao: What we are saying Rashmi I think on an overall basis our plans for the year have not significantly changed but at the same time we are very cautious to give you any kind of guidance for either the future quarter or the future year, so we will refrain from answering that specifically.

Rashmi Sancheti: Can you just let me know your CAPEX guidance?

Saharsh Rao: Even in the earlier calls, we had indicated that for FY17, Rs. 30 crores planning for the year.

Rashmi Sancheti: And FY18, any guidance?

Saharsh Rao: FY18 also it will be similar because that is the maintenance CAPEX which we run for a year, it is for the plant. We have two plants, so it is maintenance CAPEX and little bit of scaling up operations. So it will be on a similar nature, it will be about similar amount.

Moderator: Thank you. Next question is from the line of Hareesha Kakkera from BOB Capital Markets. Please go ahead.

Hareesha Kakkera: I just wanted to know how much of demonetization impacted the business.

Saharsh Rao: Actually we have not really been impacted that much by demonetization since ours is mostly an export-oriented business and being a B2B company and I do not think we can say we have had any impact.

Hareesha Kakkera: And another thing, like if this spillover did not happen, what was it that the company was expecting this quarter?

Saharsh Rao: Again it is a question that we would not answer; we have never given any guidance in the past also. I think Sucheth just indicated that this will be lower approximately 6% to 8%, so I think further than that we would not like to comment.

Moderator: Thank you. Next question is from the line of Ranvir Singh from Systematix Share. Please go ahead.

Ranvir Singh: What I wanted to know, you said 6% to 8% of Q3 sales have been lowered, right?

Saharsh Rao: Yes, so that is one component Ranvir.

Ranvir Singh: No, I am not getting. It is 6-8% of overall sales, right?

Saharsh Rao: What we meant was Q3 would have been higher to the extent of 6-8% had it not been for this spill over.

Ranvir Singh: On Q-on-Q basis say 11% decline so as compared to Rs. 144.4 crore in Q2, the Q3 should have been you said 7%-8% higher than Q2 or?

Saharsh Rao: That is 7%-8% higher than Q3, what we have actually declared in Q3, 6%-8% higher.

Ranvir Singh: Okay, so even this higher does not explain how the EBITDA should go, should we just like 11. this percent. So it seems that there has been other factors also impacting our profit during this quarter?

Saharsh Rao: No typically in Q3 also Ranvir if you look at the past trends, Q3 tends to be a slightly lower quarter because it is a financial year ending for most of our other customers also, so historically if you look at the company, Q3 has always been a little bit down, so taking all this into consideration, I think it is pretty consistent what has happened, so like we were saying earlier, for the whole year we are still going as per plan.

Sucheth Rao: I think the EBITDA margin also is a factor also of operating leverage Ranvir, so I think, the higher revenues we recognize for the quarter, and the EBITDA margins will increase to that proportion.

Ranvir Singh: Yes I understand, even if taken a higher end of EBITDA margin nearly Rs. 10 crore saw a limp on Q-o-Q basis actually seems that there has been more than what the niche segment, the contribution we have missed out, so that one thing I understand that and historically also there has been lower ring but just I wanted to know apart from this in other expenditure do we have anything one off or non-recurring?

Saharsh Rao: No Ranvir basically if you look at the first two quarters, the revenues were in the range of about Rs. 150 crores, the third quarter the revenue is about Rs. 132 crores so you can see that there is a variance of about Rs. 18 crores in the terms of revenue for Q3. If you look at the gross margin levels, we are at about close to 50%, so that is where you are actually finding that a large amount of this impact is emanating from the decrease in sales and that is where it is effecting the EBITDA but if you look at the cost lines, they are largely in line with the earlier two quarters.

Ranvir Singh: And any particular reason why this has been a spilled over because we are in process of ramping up in different geographies, so this is normal in this business to have this kind of lumpiness?

Saharsh Rao: Yes one it is normal in the business Ranvir so even if you referred to the cost that we have had previously we have always spoken about the lumpiness of the business and our optimism on the long term growth rather than the quarter to quarter performance and we have been very explicit about it. Apart from that Ranvir what else has happened is like I was saying earlier it is the financial year end for our customers, so they are busy kind of closing their books, lot of our business because 28% of our sales also came from our contract manufacturing business and the nature of the business is such that it depends on lot of clearances from customers whether it is documentation or pre shipment samples and since Q3 also coincides with Christmas holidays overseas that also creates a little bit of an impact and that is partly reason why we are not, though we could have done better we are not allowing by it and that is why our plans for the whole year are still intact. I hope that makes sense.

Ranvir Singh: And for CMS business, what has been the revenue, it is 25% you said of the operating costs that is including other operating income, right?

Saharsh Rao: Yes approximately 25% of Rs. 132 crores.

Ranvir Singh: Okay so that is something Y-o-Y growth of 74% growth, so this calculation is right?

Saharsh Rao: Yes.

Ranvir Singh: So, whether we are giving any, though we do not give guidance but just I wanted to understand perspective of, growth perspective that growth momentum is likely to continue FY18, would be higher than FY17 or?

Sucheth Rao: So, I think it continues to remain what we believe we have said in the past Ranvir which is approximately around 20% year on year growth and because of this growth and better EBITDA margins I think better operating leverage, EBITDA margins also gradually going towards 20%, I think as Sucheth has explained, yes maybe Q3 is not kind of linearly in that path but I think we are still on the same trajectory.

Ranvir Singh: And effective tax rate also seems to have gone up during this quarter versus Q2, so any particular reason?

Saharsh Rao: Ranvir the tax rate for the current quarter is about 35%, it has a small element of just about Rs. 8 lac which is pertaining to previous year which is about 1.5%, so the effective tax rate even if the earlier two quarters is about 32%-33%. Just we had a 1.5% prior period line in the tax line and that is where you will find the tax is lightly higher at 35%.

Ranvir Singh: On annualized basis what should be effective tax rate?

Saharsh Rao: The effective tax rate without the merger consideration is about 32%-33% Ranvir.

Moderator: Thank you. Next question is from the line of Shriram Rathi from ICICI Securities. Please go ahead.

Shriram Rathi: Just two questions more, one is on the margin side I mean this quarter it is 11.5% versus 15.8% on Y-o-Y basis, so just wanted to check this spillover of revenue was that something that the cost have already been booked in this quarter and revenue will be coming in the coming quarter?

Saharsh Rao: So, I think your question about the spillover, what was the question about the booking?

Shriram Rathi: The question is basically the booking of revenue has been deferred but has the cost already been accounted for in this quarter or that will also be booked in the coming quarter along with the revenue?

Saharsh Rao: The operating costs have been booked in the quarter, Shriram.

Sucheth Rao: Since it is a fixed cost the cost and everything was accounted for but unfortunately the sales are the ones that got spilled over.

Shriram Rathi: So, in that case will it be possible to get some kind of understanding in case of normalized quarter what would have been the margin in this quarter had the revenue would have been in this quarter itself and costs also, what would have been, had been like 13%-14% or it would have been 15%-16%, something like that?

Sucheth Rao: We have not made that calculation because at the end of the day we have reported on the numbers as they have happened but like we were saying earlier I think it is a Q3 performance and not for the whole year. So we do not expect that; this is altered what we had planned for the whole year that is still intact, which have been given of more significance.

Saharsh Rao: And I think based on the 6% to 8% approximation shared and looking at our gross margins and all, you can make that calculation. We would not want to spell it out so.

Shriram Rathi: And this spilled over of sales that we are talking in Q4 largely, is that correct?

Saharsh Rao: Yes.

Shriram Rathi: And lastly on second, I think we had two NDAs which were in the pipeline and it was supposed to be like we were supposed to start commercial supplies in case of successful completion of the trial for the innovator probably by FY17 end, so any update on that; I think one was orphan drug and one another product?

Saharsh Rao: I think with regards to those specific filings Shriram we would not like to comment on what the status is as of now, I think at the end of the day what we would like to do is just continue to share our qualitative information on terms of how our pipeline or how our portfolio CMS projects are looking like but again I think just due to the nature of the contracts we have with these customers, it is very difficult for us to share very specific insights on what exactly is happening to these contracts. So I think what is important from the CMS business point of view is that the portfolio continues to increase, so as we mentioned in our opening remarks today also we have added, four new molecules have been scaled up in the CMS front this quarter. I think they are all continued to add to the basket and eventually I think as these molecules advanced, some of them may fall out which is inevitable, some of them or few of them will commercialize but beyond that we would not like to comment on these two specific molecules.

Sucheth Rao: So just to add to that, I think we are very passionate towards increasing the number of molecules in our pipeline, in our portfolio and our goal is to keep maximizing those opportunities. From our point of view, we really cannot get caught up in any single molecule because that is the prerogative of our customers. As a pure contract manufacturing organization, we earn our revenues and profitability based on the number of opportunities in our pipeline and the conversion rate of those opportunities rather than any single opportunity, so both internals of our discussions and reporting; we actually focus on the number of projects and molecules rather than any specific molecule.

Shriram Rathi: Was there any increase in the commercial project this year, like four which we have added and nine are commercial right now, so those nine were nine only in Q2 or was there any change?

Saharsh Rao: So this year two projects are coming into commercial phase Shriram.

Shriram Rathi: In FY17?

Saharsh Rao: Yes, two additional.

Sucheth Rao: So what will happen Shriram is that as we add these three or four molecules every quarter, some of these will keep getting into that commercial phase in the subsequent year right, so our goal is to keep feeding that pipeline, some of them will actually attain commercial success and some of them will obviously not get converted or will never see the end market. So as we keep adding these new molecules that you saw as part of the announcement, the number of commercial molecules also will increase as we go forward.

Moderator: Thank you. Next question is from the line of Pritesh Chheda from Lucky Investment Managers. Please go ahead.

Pritesh Chheda: Sir what is the status of that scheme of merger and now would you be able to share the nine months performance of those three companies, at least in the profit numbers?

Saharsh Rao: Yes, so the status as it stands is that we had filed post the board approval for the amalgamation scheme in the meeting that happened in November, we had filed the draft scheme with SEBI, subsequent to that SEBI had few routine queries which they had raised, for which we had responded to and based on expected timelines, in the third week of January they gave us a 'No Objection' letter, subsequent to that we are preparing to file the scheme now with the NCLT, Hyderabad, for which some formalities are being completed and we expect that things will continue to go as per plan and if so, we should be able to complete the amalgamation by July or August assuming that there will be no extraordinary delays. With regards to the NPRPL nine months' performance, the accounts of NPRPL Q3 has not yet been finalized but those numbers can be made available. We will in fact have them shortly, maybe post them on our website. Again I think the performance of NPRPL also has been more or less as per plan, there has been a slight impact in Q3 similarly what we had for NLL but again I think the overall plan remains intact. We will share those NPRPL numbers on our website shortly.

Pritesh Chheda: Can you give the H1 number because when you announce this that time only Q1 number was there?

Sucheth Rao: I will get back and anyhow we are posting it to the website, we will post all the three quarters.

Pritesh Chheda: And my second question is, on the mix side, was the mix intact or there were any changes in the mix of the business and in your overall business plan for the next three years, if you could spell out the mix element in that business plan?

Saharsh Rao: I think the mix so far year to date has been more or less on plan, as Sucheth had indicated some dip in the niche segment which we expect to recover in Q4 but other than that things are more or less on plan. CMS is growing at a higher growth rate, again that is as per plan, The Prime will continue to grow at a lower growth rate**,** I think if you kind of look at a three-year horizon, we expect CMS to probably keep growing higher, maybe upwards of 35% or more from a sales point of view but again you know that is too specific guidance for us to give.

Moderator: Thank you. Next question is from the line of Akhil Jain an Individual Investor. Please go ahead.

Akhil Jain: The current US administration is creating a lot of pressure on American companies to produce domestically and like turns back you know there were pressure has been built on Pharmaceutical companies to not outsource, you know to make APIs domestically also. So I was wondering what your thoughts on that are.

Sucheth Rao: Akhil I think all of us are sensitive to that and that something which is being widely discussed now; however if you look at the US historically there have not been a strong base for API manufacturing, though the US had some API manufacturing, they were never the leaders of API manufacturing and did not have a large manufacturing base as such. So most of the API manufacturing was actually done in Europe several years ago before Indian and Chinese companies ended up taking the leading position for it. So what we hear from the market and what we hear from other investment banks and Pharmaceutical companies is that if there at all is going to be a risk, there is going to be a risk of finished dosage manufacturing moving to the US and if finished dosage manufacturing moves to the US then there is actually going to be more pressure on API's companies such as us to increase the output in order to maintain the balance in cost of goods. So from an API company's point of view which we are, we really do not see it as a problem or a pressure on our own sales or markets but there is actually maybe an opportunity to increase sales if anything else. So, I hope that makes sense to you.

Akhil Jain: Okay how long does it you know they would not be currently, if they are not producing API, they would not be having infrastructure as well in the US?

Saharsh Rao: No, they would not be having their infrastructure and they do not even have the expertise to build up the infrastructure now, so currently if at all manufacturing is going to be done in the US, it is going to be, there is going to be a lot of pressure on the kind of jobs that have moved out in the last 5-10 years. Not to build up new manufacturing capabilities rather than to rekindle the older manufacturing capabilities.

Akhil Jain: In anyways how long do you think it takes to setup an API infrastructure, from the start getting the expertise and so maximum companies would want to do that?

Sucheth Rao: It depends whether you have the experience or not, if you have already had experience of it, then you could probably do it in a couple of years, if there is no experience of it, it could take forever because it is a highly-regulated market space, right? So, it is just not about setting up infrastructure but it is also about having thus supporting facilities for waste treatment, for safety, getting the permissions, having the regulatory framework for approving the manufacturing process, getting the license, so it is just not about investment and infrastructure, it is also, all the licensing and everything else that goes with it, which typically cannot be done in a short period of time.

Akhil Jain: Also another thing I wanted to ask you is in the contract manufacturing business division of yours, what are the processes that they outsource to you in that?

Saharsh Rao: Most of our contract manufacturing business is API manufacturing and this involves either typically clinical stage APIs or many times even commercial scale APIs which are still under patent. Our expertise as you probably know is mostly in the areas of process chemistry, analytical development and obviously GMP manufacturing, so that is the areas that we focus on, we refrain from doing a lot of work in early stage chemical development.

Akhil Jain: So, how is the GDS business different from your CMS business, I believe the GDS is also is basically selling APIs only, right?

Saharsh Rao: Yes, I will try to answer the question very briefly in the interest of the call but we can obviously connect offline to discuss it more, the GDS business is involving more of generic APIs, APIs which are under parent expiry and APIs typically where we do not have exclusivity, which means that for one product we sell to multiple customers. Typically, in the CMS business it is exclusivity, so a product we sell under confidentiality only to a specific customer.

Moderator: Thank you. As there are no further questions from the participants I would now like to hand over the floor to the management for their closing comments. Over to you sir.

Saharsh Rao: Thanks again everyone for your questions. I think it was very useful for us to hear those questions and also respond to as much as we could. Again before we conclude the call, I would also like to Anil, our CFO has decided to move on, in fact he has got an exciting opportunity and when we discussed it we felt that this was a mutually beneficial move for both sides. Today we put it in front of the board and the board has also accepted his resignation, so obviously, we will be missing Anil in this organization and we wish him all the best on his future endeavors. So, notwithstanding that I think this was a good call. We appreciate the time you take to ask us all the questions and please continue to do so and it is always our pleasure to be on this call. Thank you.

Moderator: Thank you very much sir. Ladies and gentlemen on behalf of Neuland Laboratories Limited that concludes this conference call. Thank you for joining us and you may now disconnect your lines.