"Neuland Laboratories Limited Q2 FY19 Earnings Conference Call"

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Moderator: Ladies and gentlemen, good day and welcome to the Neuland Laboratories Limited Q2 FY19 Earnings Conference Call. 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 phone. Please note that this conference is being recorded. I now hand the conference over to Mr. Diwakar Pingle from Christensen IR. Thank you and over to you sir.

Diwakar Pingle: Thanks, Aman. Welcome and thanks for joining the Q2 FY19 earnings call of Neuland Laboratories. We do understand that there has been a bunching up of calls of the pharma sector today, so must appreciate you guys actually logging into our call. Please note that we have emailed our press release to everyone and you can also see the same on the website as well as the stock exchange.

To take us through the results of this quarter, we have with us the management; Mr. Sucheth Rao – Vice Chairman and CEO; Mr. Saharsh Davuluri – Joint Managing Director and Mr. Amit Agarwal – CFO along with other members of the management. We will be starting this call with a brief overview of the financials given by Amit which will then be followed by business highlights given by Saharsh and then we will move to the Q&A.

I would like to remind you that everything that is said in this call which reflect any outlook for the future or which may be construed as forward-looking statement must be viewed in conjunction with the risks and uncertainties that we face. These are unpredictable, but not limited to what we have mentioned in the prospectus filed with SEBI and subsequent annual report which you can find on the website. With that said, I will now hand over the call to Amit. Over to you, Amit.

Amit Agarwal: Thanks, Diwakar. Good afternoon ladies and gentlemen. A very warm welcome to all of you for joining this call. I will first touch upon the financials followed by Saharsh talking about the business highlights after which we will open for the Q&A.

In terms of financials on quarterly basis year on year, total revenue stood at Rs. 169 crores for Q2 FY19 as compared to 130 crores in the corresponding period of the previous year reflecting an increase of 30%. EBITDA stood at 15 crores as compared to 14.4 crores in the same period. This translates into an EBITDA margin of 9% as against 11% in the corresponding quarter of FY18. Net profit stood at Rs. 4.4 crores for Q2 FY19 as compared to Rs. 2.4 crores in the corresponding period of the previous year. On the half yearly basis, the total income was Rs. 324 crores as compared to Rs. 250 crores in H1 of FY18, an increase of 30%. EBITDA stood at almost the same level as last year which is 25 crores. This translates to the EBITDA margin of 7.8% in H1 of FY19 as compared to 10% in H1 of FY18. Net profit stood at Rs. 4.8 crores for H1 FY19 as compared to 3 crores in H1 FY18, an increase of almost 60%. The debt as at the end of Q2 FY19 was around Rs. 228 crores and the cash and bank balances were around Rs. 37 crores. I will now hand over the call to Saharsh to give his perspectives on the business.

Saharsh Davuluri: Thanks, Amit. Good afternoon again ladies and gentlemen. I will try to summarize the performance of the quarter with a few key points and then open it for Q&A. I think one we have seen very robust growth in revenue and that is the continuation from Q4 and that resulted in us having highest ever sales revenue this quarter. The growth was largely driven by the GDS business, both the prime as well as the niche business; however, the contribution from CMS was suboptimal. In addition to that, we have also seen a continued challenge on the raw material prices and as you can see that along with the suboptimal CMS revenues have contributed to low margins. While the RM price increase continued to impact the margins. we have been able to partially offset some of the impact through customer price increases and also by backward integration which has been now pursued as a very important strategy for some of our key intermediates.

Another highlight I would like to emphasize on is that we have added two projects this quarter both commercial stage for the CMS business, which because of the fact that they are commercial in nature will add significant revenue to our business in the medium term. In addition, I would also like to share that we continued to see the lumpiness in the CMS business and that is largely driven because of the relatively few molecules that we depend on for contributing to revenue to this business. That also indicates that we are still in the early part of the maturity cycle of the CMS business and as we continue to go on our path, I am pretty confident that we will see stability as well as growth from the CMS business and that will also help us on the margin front.

Another update that I would like to give is that the work at our newly acquired facility is progressing also in line with expectations. In fact, this quarter, we started delivering intermediates for our own products like Dorzolamide and Mirtazapine which is again part of the backward integration strategy that I mentioned. More importantly, we will see significant impact coming from the last quarter this year in Q4 where we will start delivering an intermediate for Levetiracetam which as you know is one of our largest molecules in GDS and is also currently facing significant cost pressures because of the escalating raw material prices from China. I think in terms of top-line, the significant contribution for this newly acquired facility will start from FY20. These are the few key points that I wanted to highlight ladies and gentlemen. Now I would like to open the floor to Q&A and then Sucheth, Amit and myself would be happy to answer any questions that you might have.

Moderator: Thank you very much. Ladies and gentlemen, we will now begin the question-and-answer session. The first question is from the line of Amey Chalke from HDFC Securities. Please go ahead.

Amey Chalke: I have two questions. First is related to gross margins. I understand that there is a price hike in the raw material, so if you can give colour on which all the products which are affected by this raw material price hike and the steps you have taken - you would be manufacturing intermediates for some of these products, so how much gross margin improvement you will seek going ahead and from which quarter, we should expect this to happen?

Amit Agarwal: The first part of your question where what all product got impacted by the price increases - if I look at my prime and the niche category product, essentially the prime category products, almost all of the prime category products got impacted, but the major products which are our high volume products like Ciprofloxacin, Levetiracetam, Enalapril Maleate, all these products got impacted and margins were significantly impacted for especially Cipro and Levetiracetam but there were some other products like Mirtazapine, Levofloxacin where there was RM price impact but we could comfortably pass on the cost to the customer. In terms of Levetiracetam, what Saharsh mentioned that Q4 onwards, the shift comes under control with our in-house manufacturing and I think Sucheth can throw a little more light on how we are handling the backward integration and handling the situation on raw material price increase going forward.

Sucheth Davuluri: I think Amit's response was pretty much in line with what is happening, Amey. The only thing I will add to that is that in spite of the difficult situation that we are facing with the supply chain that the entire pharmaceutical industry is impacted by today. I think you will be glad to note that as far as our overall commitments to our customers are concerned, we met our commitment on each and every order, so our due date performance is north of 95% today. We hardly have any orders in the system where we are beyond the committed date to the customers but having said that we had to pay a price to secure the raw materials to make sure that we continue to be a reliable partner to our customers. Given our acquisition of this facility back in December, the backward integration actions we have taken, we are in a fairly good situation, but that situation will get much stronger as we scale up these products and the intermediates kick into full commercial supply both in terms of margins as well as continuity of our API supply.

Amey Chalke: Then the second question is just linked to this that the currency movement has been very substantial. It has depreciated around 11% and we have around 70% export of our total top-line. Why that has not reflected in our gross margin, is it that things have worsen on the raw material price hike, that is why the margins have been stable?

Amit Agarwal: We did have positive favourable impact, but the raw material price increase has been very significant, so that has not helped in terms of gross margins very significantly.

Amey Chalke: And just to push on this question only, so to what extent you will see this gross margin improving going ahead, will it come back to the original levels?

Sucheth Davuluri: Amey, our expectation and our goal also to make sure that it does go back to the original level. So the whole idea for taking the backward integration in unit 3, the fact that we are also contract manufacturing some of our intermediates in India and also qualifying multiple sources, the margins will definitely go back to the original level. The good thing is that we have protected our business, so we haven't lost customer or an order because we couldn't supply inspite of the extremely volatile situation in China.

Amey Chalke: And just second question on the revenue side, so our prime segment has reported of 100 crores plus revenues for last 2 quarters, so is there any shift in stance which we have taken two years back to focus on the niche segment more and reduce the contribution of the prime segment?

Amit Agarwal: We see it as a good shift Amey, because as you probably can guess prime segment is also where lot of companies struggle to add more volume and value as well because these are the more mature products as they are in the middle of their life cycle. For us, it is a very positive sign that the prime segment has grown because it goes back to our bread and butter products, the fundamentals of the business. As far as the specialty segment is concerned and the CMS, obviously those are the businesses which are growing but as we have said earlier, those are the numbers which will also continue to be lumpy because those products are growing, and we are either launching them, the delay and approvals. Though we have added two new commercial products in the CMS space, in this particular quarter, they haven't been a big contribution from the CMS segment. Having said that we believe that will always be limited to a quarter or to half a year, but as far as the overall business is concerned, there is no shift in strategy, there is no shift in how we expect each of these businesses to individually perform, but we will see that quarter to quarter, half year to half year lumpiness because obviously both the specialty as well as the CMS business are in their early stage of the maturity cycle. So until those businesses get to the critical mark, we will see this lumpiness but there is no strained change in strategy neither the expected performance.

Amey Chalke: And just last question on the CMS side that we supply one of the products for the Huntington's disease and there has been good traction for our client in the US, so is there any feedback from the client on improve orders going ahead for our API supply?

Saharsh Davuluri: See Amey, I won't comment specifically on any molecule but I think generally speaking if you look at the CMS pipeline, yes, we acknowledge that our pipeline has one molecule which is more newer, it has been recently launched in the market and as happens with any new launch, there is a little bit of uncertainty in terms of the offtake of volumes of the product. For the newer molecule that we launched, one thing that gives us a lot confidence is that we are the only supplier for the API and second of all that the drug is still in its early phase of launch, and therefore the kind of visibility or predictability we get from customers for such phase of launches is very low. In fact, our customers always give us very conservative outlook and we also operate on such conservative outlook but as the drug picks up, we should see the order flows and I am sure that will reflect in our CMS revenues as well, but I think at this point, we don't have any specific data or anything except to say that today our CMS base as we have reiterated in the past has about 5 or 6 molecules, but in reality, only 3 molecules contribute to the significant part of that base, out of which one is the new drug that just got launched as you were referring to. Therefore, there is still a lot of lumpiness in this business. As the drug continues to do well and our other molecules also continue to grow, we will see more stability in this base, so that is perhaps the only outlook we can share at this point.

Moderator: Thank you, Mr. Chalke. The next question is from the line of Abdul Puranwala from B&K Securities. Please go ahead.

Abdul Puranwala: I just have a few questions on the CMS part only. Can you tell me what would be the typical credit period offered to the CMS clients?

Amit Agarwal: The credit period would generally be in the range of around 60 days.

Abdul Puranwala: My question was that the fall what we have seen in the CMS in the first half, could that be attributed to the customer withdrawing the final molecule from the market?

Saharsh Davuluri: Abdul, if you look at our CMS revenue and just for analysis purpose, you compare the CMS revenue with the previous year CMS revenue, there are two segments of business that come under the CMS business. One is the R&D related soft work or the lab-scale scale work that gets built. Second is the commercial manufacturing of CMS molecules which are already commercial. These are the two segments within CMS. Now whatever lab work happens, those projects are more like custom synthesis and these are a lot more, these are newer projects that come in and there is not necessarily any continuity in those projects, so many of those projects come and they go and they might not come back, but the commercial molecules which is the second segment contribute to a stable base of revenue for the business, so like any of the CMS molecules, the commercial CMS molecules we refer to those 5 or 6 molecules. All are part of the second segment.

So with regards to your question on have we lost projects compared to what we have and is that the reason why our revenue has degrown, the second segment of the business which is the commercial CMS molecules, there has absolutely been no loss of business for Neuland. I think the important thing, and it is a very pertinent question from your side is that we have been able to not only retain but also add two more projects this quarter on the commercial side of the CMS business. On the R&D activity or on the soft work related work on the custom synthesis part, volatility of projects continues to be there and that is why we have that chart that we prepare and we share every quarter in terms of total number of projects. If you look at that also, as of this quarter, we are showing about totally 46 projects which are live in Neuland. The last quarter of this financial year, the Q1, we had 44 projects, so now between 44 and 46, yes, two projects are added, but perhaps one or two projects which were may be in the early stage clinical may have dropped as well. So the short answer to your question is that the commercial scale that has been absolutely no attrition of projects and therefore there is no cause of concern from health of CMS business point of view. From a small-scale projects of view, there will be attrition because phase 1, phase 2 candidates do get dropped off and newer projects do keep coming in, but that is the nature of that business and that is something that we have factored in as part of our CMS business.

Abdul Puranwala: Just to get some more clarity on this, on an annual basis, would it be possible to give the breakup on the CMS segment from the clinical and the commercial side?

Saharsh Davuluri: We can definitely do that. It is something that we have to probably go back and do but intuitively it will be majority from the commercial side, but we can get back to you on that.

Abdul Puranwala: And just a final question, when you mention that 95% of the contracts what we had in place, those have been fulfilled, by when would we enter into new contracts with client and would that be at a higher price or there is a certain agreement level at which we will have to maintain the pricing?

Sucheth Davuluri: Abdul, the question you are asking is that as we mentioned earlier, 95% of the contracts would be in place and therefore not open for negotiation, will you have any leverage when it comes to negotiating new contracts for prices, is that what you are saying?

Abdul Puranwala: Yes.

Sucheth Davuluri: And this is in the context of raw material price increases and what is happening in the supply chain, is that the contract you are asking in?

Abdul Puranwala: Yes.

Sucheth Davuluri: So just to go back, Abdul not all of the businesses or the customers have fixed price contracts. We do have flexibility in terms of going back and negotiating the prices in case, we see an escalation price, however, in lot of the cases we have to take a call between whether the price increase can be completely passed on to the customer, will that still enable our customers to be competitive in the market or could it be so severe that we could end up closing the whole product, therefore for every price escalation, we make a conscious call on a case by case basis as to where the price escalation is possible while protecting the market share and where the price escalation is shared between us and the customer, so that we can still protect the market share and therefore when prices go back to normal or a backward integration strategy, then we still be able to retain the business as well as the profitability. It is a conscious call we take and obviously any new contracts that we negotiate are done based on the current prices anyway.

Moderator: Thank you. The next question is from the line of Kunj Bansal from Acepro. Please go ahead.

Kunj Bansal: I refer to the annual report in which you had said that all the three lines of businesses, CMS, niche business and GDS will do well in FY19, although you commented about these but we have already seen the first half going away, so what is the likelihood that in FY19 positivity still remains or has it shifted to FY20?

Sucheth Davuluri: Thanks for pointing that out Kunj. I just refer back to our understanding and the communication we have given about all the three areas of business. We have always maintained the position Kunj that both the speciality or the niche APIs or the CMS business for us, though we have had a lot of success in it and there is a lot of opportunity, we haven't lost a single customer from the last several years. We still in the early part of the maturity cycle as far as these businesses are concerned, therefore not only in this quarter even going forward until these businesses get to a critical mark, we do expect that they will be extremely lumpy in nature and therefore you would note that even in the previous call, we have stayed away from giving any kind of guidance and that has been always a conscious call because we know that the business is what it is and we can't give it a definitive angle because it just doesn't exist. Having said that and being consistent with the previous comments we made, the strategy for these businesses, how we expect them to perform, I think as far as the management and the Company is concerned, we have not made any significant adjustments to our long-term plans. At the same time, you are absolutely right. In the first half of FY19, the business as we had expected did not happen, we saw that the business is much stronger compared to Q1 and Q2 in Q3 and Q4 from a CMS point of view, but does that mean that we will see that consistently happen every quarter, absolutely not, I think it will continue to be lumpy.

Amit Agarwal: Just to add Kunj, I think in terms of our business I would say, business has actually grown, an activity that is what to be expected and we delivered in terms of growth of the business. Bottomline got impacted because of factors, which were essentially not in our control. Yes, the CMS was one part, which we have always maintained that it is going to be volatile and continues to be strong, but otherwise on top-line I think whatever challenges we had faced in FY18, we have got over with those challenges.

Moderator: Thank you. The next question is from the line of Faiz Menon from Fidelis Wealth Management. Please go ahead.

Faiz Menon: I had a specific question, actually couple of them. One with regard to Salmeterol, I was wondering if we have any further information is shared, I understand approval might not have come through, but any expectations on when we might see that actually coming through?

Saharsh Davuluri: I think for us from the last quarter there hadn't been any significant update in terms of new approvals especially in the US market. The products for us continue to move in the Europe market. We have seen good growth and sales over there and our customers in Europe continue to expand their registrations in other European countries say for example, we started off in Scandinavia now and we are all over in Eastern Europe through multiple customers but having said all that US is the big market. Everyone is really waiting for that to open up, but we don't have any kind of a significant or substantial update from our customers that could tell us anything. We are ready, our plant is all geared up, we have starting materials available on short notice and we think it could happen any time this year or next year.

Faiz Menon: The other question is with regard to plants as well as in terms of capacity utilization of the plants in bottlenecking that we went through couple of quarters ago. How we are looking on our Cipro volumes? Are we able to be met our demand or we have to still adjust a little bit? How is that going?

Sucheth Davuluri: That is a good question, Faiz. I think exactly 3 quarters ago, we had mentioned that there was some imbalance in capacity and that we are in the process of moving products to other facilities, so line balancing and that exercise is more or less complete and it has also reflected in the increase in sales and I was making an earlier comment that as it stands today, we have close to zero orders for which we are behind in terms of committed delivery. I think we are happy with the situation we are in and the acquisition of the new facility added about a third of our overall capacity, so right now efforts are being made to get that facility fully operational both in terms of backward integration and adding new products as well. From an overall capacity line balancing, capacity utilization point of view, we are in a good shape, but at the same time, we continue to be cautious because the market is volatile, the demand is volatile, so we have to be geared up to meet the market requirement. Our efforts to qualify multiple site from multiple products continues as we forecast the demand for our existing products as well as new products.

Faiz Menon: Would you then say that Cipro and Levo levels in terms of your demand are back to normal or above normal, what do the levels look like right now?

Sucheth Davuluri: Yes, I think they are back to normal, it has reflected in the numbers and that is why we are also seeing the prime segment growth. So even on the volume on volume basis, Cipro has gone up this year. We are continuing to add more customers as well, I think we will expect the Cipro volumes to grow. So I think one of our relentless strategy that for the product that we continue to manufacture unless it is obsolete or it has been discontinued in the market, we will continue to promote it, add new customers, do life cycle management by reducing the cost and increasing volumes.

Moderator: Thank you. The next question is from the line of Sahil Shah from Ocean Dial. Please go ahead.

Sahil Shah: I just wanted to check on your CMS pipeline and when look at it compared to Q2 FY18 to Q2 FY19, on the commercial side, we will be in increase of two products whereas on the development side there has been an increase of three. What I wanted to know is that on the commercial side and at the development side, can you just give an idea of what the potential revenues could be from these. I know it could, it is very sort of lumpy but any idea on how much revenues these could increase over the next couple of years?

Saharsh Davuluri: Sahil, I think just to clarify for the benefit of everyone, what we referred to as development in that column refers to molecule which currently where we are doing validations in the plant and it is a natural process and once validations are complete, they will add to the commercial pipeline. So that number will move into the commercial pipeline, so right now we are at 12 and the 12 will increase and that number 9 will reduce once we have completed the development. Having said that, the range of commercial revenue that could come from these molecules varies a lot. So for example, we talked about two commercial projects now, one of them is actually an intermediate for an API for a very large pharmaceutical company and we expect that revenue could be in the range of 10 to 15 crores per year. That is the commercial revenue that we expect. Another project is actually an API, which is a fairly complex API and we don't want to disclose so many details about it, maybe once it moves into commercial category, but that is something that we expect revenue will be somewhere from 50 to 100 crores per year. There is quite variance in terms of the annual revenue opportunity for each of these molecules, but it is anywhere in this range and depending on the complexity and clinical indication and the markets etc., those are what are determining the annual potential revenue.

Sahil Shah: If you take your commercial, how much you think your share would be because is that something that you could improve going forward with better marketing efforts or is that something that happens when it happens?

Saharsh Davuluri: If you look at our commercial pipeline today, I think the gentleman earlier, Abdul also had asked the same question, we have 5 molecules which are in our commercial pipeline. If you look at our overall revenue, I was telling that majority of that number, I don't have the exact number, but majority of our CMS revenue may be 80% or so comes from these molecules, but then within that if you do a rough extrapolation of 80%, then you can say that 5 molecules are giving us that much. If you look at our historic numbers where we have done about 100 crores a year in CMS and if you do an extrapolation of that, you are looking at 80%, so 80 crores coming from 5 molecules, so the average has been about 16 crores. I was just doing basic arithmetic here.

Sahil Shah: That is what you have done, what I am saying is that in terms of market share that you would have, do you have the potential for these two increase or this is what it will remain at 16, growing at whatever depending on the demand, or do you see that because of your cost advantage you can really increase the share in these?

Saharsh Davuluri: Understand your question Sahil. So I think in terms of the potential to increase the market share for these products, I think one thing I will clarify is that since these are all CMS molecules, we are working with the innovators and these molecules don't have any generic competition. In terms of the spread we are, one of the two supplies for these customers. Having said that the volume of the APIs also tend to grow because the drug is expanding. These drugs have been in the market for 2 to 3 years and they may be expanding in terms of volume or may be our wallet share vis-à-vis the other supplier is also increasing. So for these molecules that are already in our commercial, in general we are seeing an improvement in terms of growth in terms of volume and revenue, but in terms of market share which is the question you are asking for the end market share is something that remains constant because these are proprietary molecules, then our customers have 100% market share for them anyway.

Moderator: Thank you. We will move to the next question that is from the line of Suresh Dhuramshetty as an Individual Investor. Please go ahead.

Saharsh Davuluri: The question that was asked was about the facility that Neuland had recently acquired. The gentleman was asking how do we intend to use that facility given that it has several production areas, what are Neuland's plans to utilize that facility and by when will it be fully operational. The response of that question would be that as we had already indicated, we have started operationalizing this facility earlier this year and currently we are utilizing two of the production blocks out of the 5 production blocks for backward integration activities. We also intend to use these production areas for scaling up some new products as well, both for GDS as well as CMS; however, as Sucheth had mentioned in one of the earlier responses, we expect the facility to be generating revenue only in FY20. For this year, we expect it to be largely used only for backward integration purposes. We are confident that in the next 24 months, we will be able to utilize this facility almost completely.

Saharsh Davuluri: The question is being asked is about revenue guidance, but again our response to that is that as policy we have not been giving revenue guidance and we don't intend to give any kind of guidance given the kind of uncertainties that exist in our business. So while we are generally very optimistic about our business and we have given various responses to various questions in the call today, we would encourage you to make your own conclusions rather than us give any kind of guidance.

Moderator: Thank you. Ladies and gentlemen, that was the last question. I would now like to hand the conference over to the management for the closing comments. Thank you and over to you.

Sucheth Davuluri: Once again, ladies and gentlemen, thanks for being on this call and thank you for having us on the call as well. I hope we were able to answer your questions with clarity, but if you have any outstanding items, please feel free to reach out to any of us including Christensen, to clarify those outstanding queries you might have. Having said that and in light of the current quarter results, we do feel strongly about our business. It is demonstrated in the revenue growth. We are happy that our prime APIs have actually shown growth in volumes which at times can be pretty challenging to add. We do expect that our CMS segments and specialty APIs will contribute to our growth in the mid as well as long term. I think our new facility that we acquired is on-line. We had already step line intermediates for backward integration from that facility. As we have mentioned in the earlier calls with the acquisition of the new facility, we have added one third of our overall capacity for our future business growth and we expect that between these three facilities, debottlenecking actions, line balancing and full commercialization of the new facility, we will continue to grow the business the way we had envisaged it to grow. Having said that we look forward to future calls and clarifying any questions you might have and creating greater transparency for the organization. Please continue sending us your feedback. I think the way we are reporting and adding more colour to our numbers either in terms of the number of projects in the pipeline or the breakup of the prime, specialty as well as CMS business, we owe that to your feedback and we will continue to improve the way we communicate with our investors as well as our potential investors. Thank you very much.

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